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BEFORE THE

COMMITTEE ON THE BUDGET
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

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FEBRUARY 2, 15, 16, 17, AND 24, 1983

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ECONOMICS

WEDNESDAY, FEBRUARY 2, 1983

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to notice, at 10:07 a.m., in room 6202, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Boschwitz, Symms, Grassley, Kasten, Quayle, Chiles, Hollings, Biden, Johnston, Sasser, Hart, Metzenbaum, Riegle, and Exon.

Staff present: Stephen Bell, staff director; Gail Fosler, chief economist; Richard N. Brandon, minority staff director; and Kemble Stokes, chief economist for the minority.

BUDGET RESOLUTION SCHEDULE

Chairman DOMENICI. Could I have the attention of the committee members?

Mr. Stockman, we welcome you, but we will take just a couple of minutes for just a few housekeeping matters, and then we will get on with this hearing.

At our first meeting we discussed the possibility of expediting the Budget Committee's work so that we could bring the budget resolution to the floor of the Senate the week before Easter which would put us on a path of being about 1 month ahead of the final statutory date, and some 5 to 6 weeks ahead of where we have been in past years. That would mean that the week of March 7 through 11, we would have markup.

Now, I will put this calendar into final shape today or tomorrow, and circulate it to everybody. I have discussed it with Senator Chiles, and yesterday I met with Leader Baker, who in turn talked with Speaker O'Neill, about whether the House is going to be on the same kind of a schedule. From what I can tell, a final decision has not been made, but I have every indication that they too are going to be on a very similar track, Senator Chiles.

So what I would like to do is just tentatively put the committee on notice that we would hope to have markup during the week of March 7, and take the resolution to the floor the week before Easter. However, I will qualify and condition that on the following, that Leader Baker and Leader Byrd meet and talk about this, and that indeed the U.S. House is going on a similar schedule. If I find out anything to the contrary, I will promptly advise you, in which event we meet again tomorrow. We could perhaps meet a few minutes before, if that is not going to be the schedule, and talk about some other option which we could then present to the committee members.

Senator **Chiles**. I am glad to hear your qualifying remarks, because my understanding is that Majority Leader Baker and our leader, Robert Byrd, are discussing this schedule, and I would like to see agreement, if they can come to agreement.

OPENING STATEMENT PROCEDURE

Chairman **Domenici**. Frankly, I can say to you, Senator Chiles, they are discussing not only this but a much broader legislative expediting package, and I am sure we will get an answer on this very quickly.

With reference to today's hearing, I think we all understand this is our first hearing, and our witness today is David Stockman. We have a series of hearings today. I did establish last year a procedure whereby the chairman and the ranking member would make opening statements, and other members would use part of their 5 minutes as we went around the table on questioning, for both questions and opening remarks. I understand this is unique in that it is the opening day, and I am willing to discuss quickly with the committee some modification of that for the opening of the hearing. I already have, and while some want everyone to make opening statements at each and every hearing, others are telling me, let us expedite the questioning and get on with the budget resolution. So from the standpoint of the desire of the members, I am caught betwixt and between in terms of expediting the process.

I have a very brief opening statement, and I am not adverse, if the members want, if they will be reasonable, to letting anybody who wants to make brief opening remarks. I hope we are not talking about 10 or 15 minute speeches, but if that is satisfactory, I will play it by ear. I do think it is within the prerogative of the Chair to conduct the meetings, and I do not want to be arbitrary, but I do want to get on with the hearings, so if that is all right with everyone today, I will not follow the 5-minute rule, but as any Senator wants to make brief opening remarks, he should make them.

Senator Metzenbaum, you raised this issue. I am sure I have not answered your concerns in their entirety, but I tell you, I do not think I can agree to totally change the procedure where we had opening remarks by anyone and everyone each meeting.

Senator **Chiles**. I do not think we need to do that. I am glad to hear, however, of your flexibility today. I think this is something we can work out without being inflexible about everyone making an opening statement every time. It may be that we need to say the minority side is going to have a certain number of minutes for opening statements, and then we can adjust that period of time. But there are times when members other than the ranking member have something they feel they would like to say, and they would like to say it before listening to the 20 or 30 minutes of comment. I am glad to see your flexibility. If you continue to be flexible, we will work it out.

Senator **Metzenbaum**. I think both the thoughts of the chairman and the ranking member will very well accommodate the concerns

I expressed previously, and I would suggest that you and the ranking member work out some procedure that has a degree of flexibility, and yet approach the objective that the chairman rightfully has in mind.

Chairman **DOMENICI**. Let us proceed on that basis. Is that satisfactory?

Senator **GRASSLEY**. Would you repeat the procedure?

Chairman **DOMENICI**. I am not going to hold fast to the chairman and ranking member's being the only one giving opening statements. Today I will yield, and let anybody that has brief opening statements make them. However, after this meeting, the ranking member and I will agree in advance so we will have a format. Let us say that the minority wants 8 minutes of opening statements, or 10, he can decide how he wants to handle that with his members. If it gets out of hand, I can tell everyone now—we will not have an hour and a half of opening statements, whether it is Republicans or Democrats. That is not implicit in my agreement. It will be very brief, as far as we can make it.

Did you want to say something, Mr. Stockman?

Mr. **STOCKMAN**. Mr. Chairman, I was going to suggest that I fear it is the length of my opening statement that may prompt equal statements from some members of the committee. In the new spirit of bipartisanship, and solving problems that we have in this session, I will forgo my opening statement entirely. I see this flying wedge of my friends on the Democratic side of the aisle, and I am sure they are eager to get to the questions, and I am as well. And I will just ask that my statement be submitted in the record.

Senator **CHILES**. If Mr. Stockman is going to yield his customary 20 or 30 minutes to us for opening statements—go ahead.

Chairman **DOMENICI**. I would rather that you not make that statement, because more of that will justify about 30, 40 minutes.

Mr. **STOCKMAN**. It was only on a quid pro quo basis.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman **DOMENICI**. Let me abbreviate my opening statement in welcoming Mr. Stockman, and stating that in my opinion the President's 1984 budget in terms of the deficits and spendout levels is an honest document. From all I can see, the assumptions are prudent and conservative. I believe they accurately describe the hard choices that this committee and the Congress will face in attempting to reduce deficits.

Last year the President and the Congress had very different views about the economy and the nature of the budget problem. We resolved those differences with some considerable difficulty.

BUDGET GOALS

Now, I believe we have a budget that is a useful blueprint for economic recovery. It reaffirms the most important principle accepted during last year's budget debate, sustained economic recovery is not possible in the presence of large deficits which are going up in the out years instead of coming down. The deficits must be reduced if interest rates are to come down so that we can start the economy growing again and put Americans back to work. Deficit reduction, lower interest rates, and sustained economic recovery are to be the goals stated in the budget document, and certainly they are my goals. I hope they are everyone on this committee's goals. They are clearly the President's goals. I believe these will be the goals of the committee as we move ahead, while we may have differences of opinion as to how to get there.

I am convinced that recovery is now underway after almost a year and a half of universally bad news. The traditional indicators of economic recovery are now all turning up. But this sign does not mean that our problems are over.

I do not need to remind you, Mr. Stockman, that people are struggling through difficult times. Unemployment is distressingly high. Unemployment will remain very high for many months to come, even under the most optimistic of circumstances. Interest rates are still very high. Treasury bill rates have come down but the real interest rate that businesses and consumers must pay are almost as high as last year. I do not think there is any way to have recovery unless those interest rates come down further, and I mean real interest rates. These are the realities and the challenges that this budget brings to us, and brings to the budgetmakers: how to reduce future year deficits in order to sustain recovery and yet at the same time address the problems of the unemployed and achieve the other pressing national goals.

The President's budget is responsive in some of these areas. The President's budget proposes some new initiatives. We have to hear more about those in the area of unemployment compensation, training and employment. However, I expect that the committee may indeed go beyond the President's budget recommendations in these key areas.

DEFENSE SPENDING

Finally, let me mention two of my pressing concerns. First, in defense spending, spending for national defense will grow 76 percent over the next 5 years. We must continue to strengthen our defense significantly, but I am convinced that we do not have to have as much growth as the President requests. I hope we will get some cooperation and assistance from you and the Secretary of the Treasury as we attempt to set the first mark in that area of Federal expenditures.

I want the committee to go beyond the President's proposals to seek further reductions. This defense budget contains many programs that grow rapidly and that create spending wedges in the outyears. The whole objective of this budget, if I understand it, on the expenditure side, is wedged in the reverse direction, a wedge where cuts and restraints start small and grow large. The defense budget works in the opposite direction, and does so with some serious degree of growth. I am not talking about major strategic systems, but rather many of the major activities in the Defense Department that are wedged in that direction.

DOMESTIC SPENDING

I have one last comment, Mr. Stockman, on the concept of a freeze in domestic spending. I think at the outset there was significant support for the freeze concept. Indeed, I, along with many of my colleagues on this committee have advocated a spending freeze as an equitable way to administer the painful medicine of restraint.

However, there are some items in this budget that I do not really understand. How do you justify a freeze when we are eliminating the community services block grant program, eliminating the work incentive program for welfare recipients, eliminating all of the Department of Education's Indian education programs?

These are extreme actions, and they are only examples that are inconsistent with the freeze. I hope you will explain them to us. Bilingual education is down 31 percent; vocational education, if I read it right, is down somewhere around 40 percent.

Now, I understand you are talking about all of the appropriated accounts en masse being frozen at more or less the level that we are at now. I am not sure that is what you have done. I think maybe you have gone beyond this, and certainly I expect when my questioning time comes to ask you more about it.

I am pleased to yield to my ranking member, Senator Chiles.

Senator CHILES. Thank you, Mr. Chairman.

I would take my full statement and ask that it be inserted in the record.

Chairman DOMENICI. It will be inserted in the record.[1]

OPENING STATEMENT OF SENATOR CHILES

Senator CHILES. And I will make some brief remarks.

When I heard the President call for bipartisanship in his State of the Union, I was tremendously heartened by that. When I met with you last Friday for a briefing on the budget, I was impressed with the realistic economic assumptions that you used. I was so pleased that I was upbeat all weekend, and in fact, I told a number of groups and interviewers that I thought we had a real opportunity to work out a partnership and develop an effective budget.

A partnership, of course, is based on mutual concern about achieving goals, and I like the idea, because it brings out a frank exchange of views, and it brings realism to the top, and that is certainly good, because this committee in a bipartisan way wants to help the administration deal with our serious economic problems, and I think we can do it if we are realistic.

DEFENSE SPENDING

After spending the weekend digging through the numbers in this budget, I saw realism begin to slip away. I remembered what the President said about a $55 billion defense cut over the next 5 years. I did not find it in the budget. I will tell you why.

A year ago this month the President came out with a budget that no one accepted. In May, the majority of the members of the Senate and the House Budget Committees worked out an agreement with the President to reduce the size at that time of the defense increase. We set 3-year limits on defense spending. The Armed Services and the Appropriations Committees took those limits and passed laws within those limits in July, and these are now the law of the land, and any time you go above that, there has to be an increase.

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[1] See p. 9.

But in July the President said he did not feel bound by that agreement. The majority members on this committee hit the ceiling. We found that the President meant what he said in July because his year-old figures are back in this budget, and those are the figures that the President used to calculate his defense cuts. If you use the real figures, the ones the President agreed to in July, you do not get $55 billion in defense cuts. You get an increase of $2.2 billion in fiscal year 1984; $83 billion in increases over the next 5 years. Eighty-three billion dollars in increases, not a $55 billion decrease.

TAXES

The President said he wants to wait until 1986 to raise any revenues, and he wants to do that only on a standby basis, not definitely. He calls that an insurance policy for economic recovery. I think it is a bet against recovery. It will not start until 1986, and then only if the deficit is higher than 2.5 percent of the gross national product. I really do not think we can wait and increase taxes later. I think we should start by stopping cutting taxes now.

If you repeal indexing, you save $91 billion by 1988. You will save, if you repeal and cancel the third year of the tax cut, you save $274 billion, or 1.6 percent of the gross national product. Unless you do that, you are going to have deficits that are so stubbornly high that you will continue to add to Federal borrowing, and you will squeeze out private investment. On top of that you will create a system where spending goes up and revenues go down. That certainly has to aggravate inflation. I think to keep indexing, when we have the problems we have today, is totally irresponsible.

DEFICITS

Your budget would give us a $188 billion deficit in fiscal year 1984. The national deficit is going to go over $2 trillion by the end of fiscal year 1988. Along with that, unemployment remains terribly high. I do not see how we can ask unemployed people who are already paying a terrible price to just wait it out any longer. They cannot, and we should not ask them to do that, because the deficits are going to make them wait. Those deficits keep growing because of the problem—of a problem that cuts across domestic spending—a budget program that cut domestic spending by 1.2 percent, and then we added 1.4 percent to defense, and we lost, in effect, the domestic cuts that we made, and then we take another $2.4 billion for tax cuts.

Then, of course, we build in that structural deficit. I have looked at all your charts, and all of the books, as to where the structural deficits come from, but you just look at those numbers, you get 1.2 percent, you add 1.4 percent, and then you reduce tax revenues by 2.4 percent, and you come up with, in effect, what is a structural deficit coming in 1988. That is exactly the amount of your structural deficit, and I point out that that is a deficit which is going to stay there, because you are already reaching full employment. You have done everything you can for full employment. So we will have $100 billion, even under your figuring structural deficits that will run from now on, and I do not see how you could possibly have that.

The size of the budget deficits rests on a number of domestic cuts. I am not sure how realistic those cuts are. For example, a majority of this committee said we were going to make savings of $50 billion in medicare. By the time they took their budget to the floor, they went back and changed it and decided that was too big a cut, and they cut it down to $36 billion. By the time we got through the Conference, we had cut it down to where these savings over the period of years were reduced to about $17 billion.

So I do not see where you are going to get some of the savings you are talking about.

UNEMPLOYMENT

Another problem is when we are talking about a partnership, then I think both sides have to recognize the pressing concerns of each side. We Democrats share your concern about fighting inflation, and the deficits, but we also have a concern for the plight of the unemployed, and that is a concern for millions of people in this country who are without jobs. Some are caught in the recession. Some are caught in a job market that is changing. Some are caught in the change that is going on in the way jobs are created. So these people, I do not believe, can afford to just bank on long-range promises. They are hurting, now, and there has to be something to show that we share their concern for them, and we are trying to do something about it.

But if this budget is going to be credible, it will have to include some kind of jobs bill, with a more substantial training emphasis. It will have to consider cutbacks which you are proposing in housing, credit, and assisted housing. I do not see how in the world we can cut vocational education training by one-third.

So the administration has got to understand that people on our side have these concerns, and that we are going to have to have some sharing of those concerns.

BIPARTISANSHIP ARRANGEMENT

Having said all of this, I go back to the opening now, of whether we are going to have a bipartisanship arrangement. Sometimes if you are optimistic, and I am an internal optimist, you have to step out on face, and you can go out on assurances. When I look at your figures, I sure do not get any kind of assurances, but the President says he wants a partnership in this plight, and I think the people on our side should test that. I think we ought to determine, whether he really does want that, because that is an effort we have to be trying to make.

While there is no defense reduction in this budget, there is at least a signal that where you talk about a defense reduction, and that is something that was even verboten to speak about in the administration a few days ago. While there is no tax revenue in this budget to speak of, at least it can now be talked about.

So I hear the signals of a—well, let us say, someone who is in trouble, who is seeking help, and I think we on our side ought to be trying to provide that help. If you cannot find the time to do it for yourself, then I think we ought to be trying to provide that help, and I think we ought to act as soon as possible.

Chairman DOMENICI. Thank you very much, Senator Chiles.

OPENING STATEMENT
BY
SENATOR LAWTON CHILES
RANKING MEMBER
SENATE BUDGET COMMITTEE

FIRST HEARING - FIRST CONCURRENT BUDGET RESOLUTION
FY 1984

FEBRUARY 2, 1983

Thank you for coming this morning, Mr. Stockman.

When I heard the President call for bipartisanship in his State of the Union, I was pleased. When I met with you last Friday for a briefing on the budget, I was impressed by the realistic economic assumptions you used.

I was so pleased that I was upbeat all weekend. In fact, I told a number of groups and interviewers that I thought we had a real opportunity here to work out an effective budget.

But the more I dug into the numbers the more worried I became about the chances for that partnership succeeding. If there's going to be a partnership, it must be based on a frank exchange of information. It must be based on genuine realism.

When we start talking about defense cuts, we must to be clear what baseline we use to make those cuts, and whether there's really any cut at all.

When we start talking about tax policy, we will have to take a very hard look at what waiting until 1986 for a standby tax increase means versus a decision to avoid cutting taxes any further now.

When we start looking at health care reforms, we will have to talk about whether its realistic to expect $58 billion in more cuts on top of the $17 billion we passed last year.

And we will have to talk about a deficit of $188 billion in Fiscal 1984, and a national debt of over $2 trillion by the end of Fiscal 1988. We will have to talk about that because those are the kinds of deficits in your budget.

DEFICIT REDUCTION

Using current services levels as a starting point, the President's budget will cut the federal deficit by $559 billion between Fiscal 1984 and Fiscal 1988. While that sounds like progress, it still leaves us with tremendous deficits in each of those years. Taken together, those deficits are not only record breaking, they also combine to eat a record 5.8% share of the GNP in Fiscal 1984.

By contrast, the federal budget deficit in Fiscal 1981 before the start of President Reagan's program was just two percent of the GNP. If you look back a little further, you'll find that deficits were less than 0.5 percent of GNP in the 1950's; about 0.8 percent in the 1960's; and even in the 1970's, the deficit consumed just 1.9 percent of the GNP.

The deficits alone are staggering. But just the interest load for financing the growing federal debt can make you weak in the knees. The net interest costs are now over one and a half times greater than the cost of Medicare and half the cost of national defense.

And those figures just show the impact of growing interest payments on the National Debt.

By Fiscal 1988, seven years after the Administration programs took hold, the deficit will still consume a larger share of the Gross National Product than in Fiscal 1981, and leave the country with a legacy of a national debt over 2 trillion dollars.

Whatever debt the President always reminds us he inherited, it was nothing like what he will bequeath.

That's where we'll be if we do what this budget proposes. While I'd hate to think where we'd be if we did nothing, this budget still doesn't do enough, soon enough.

I want to limit myself to talking about broad themes. So let me mention just two beginning with taxes.

TOO LATE ON TAXES

I am disappointed that the President only seeks to raise $11 billion of new revenues in each of 1984 and 1985. By 1986, the national debt will increase by over $600 billion, taking it to over $1.7 trillion. That is just too heavy an anchor for us to drag.

While it is unpleasant to pay taxes, we will eventually have to pay for whatever we spend. The next round of 10 percent tax cuts will take the tax burden down to 18.7 percent of GNP by 1985. That is lower than it has been since 1960. Even in the 1950's, the federal budget was never balanced with tax revenues of less than 20 percent of GNP. In the 1960's we assumed some major social responsibilities--like Medicare, Education of the handicapped, college student aid, environmental protection, and child nutrition--which no one would seriously suggest abandoning. Yet the 1985 cost of these programs will be over 3 percent of GNP. So we just cannot meet our basic social responsibilities, domestic and defense, with taxes below 20 percent of GNP.

The President's proposal for a standby tax is not so much an insurance policy on recovery as it is a bet against it. It phases in only if the deficit is still at 2.5 percent of GNP in 1986. When in place, the standby tax would be limited to one percent of GNP. That's not enough to pay our bills. It won't do the job in 1986; going ahead and completing the full twenty-five percent tax cut won't do the job now.

CBO estimates that baseline spending will be 24.3 percent of GNP in 1985. The first two rounds of domestic spending cuts proposed by the President, and enacted by Congress, will amount to 1.2 percent of GNP in 1985. So even if we cut that same amount all over again, we would still need a tax burden of about 23 percent of GNP to balance the budget. A reasonable deficit of 1 to 2 percent of GNP would require a tax burden of 21 to 22 percent, which is substantially above the President's arbitrary limit.

In his budget document, the President shows that the 1981 tax bill cut too deeply into the revenue base, and that the 1982 bill did not provide a sufficient restoration. He also points out that domestic programs could not reasonably be cut to offset his proposed defense increases. Yet he does not show how deep tax cuts could be responsible when there was no overall reduction in spending.

Elimination of just two excessive items built into the 1981 tax bill--the 3rd round tax cut, and indexing of rates to inflation --could generate $281 billion of revenues by 1988, and eliminate one fourth of the current services deficit.

The go ahead with the planned indexing of tax rates in the fare of all our economic troubles would be totally irresponsible. If the budget were balanced, indexing might be a luxury we could afford. But we can't afford it under the circumstance. If we repeal indexing, we can save $91 billion by 1988.

DEFENSE

The President claims defense spendng will be restrained by $55 billion. But the way those "savings" are achieved is by pumping up the estimate of what he wanted to spend on defense in the first place.

When the President's February, 1982 budget ran into overwhelming opposition, he negotiated with the majority on the Senate and House Budget Committee a three-year defense spending figure. It was included in the First Concurrent Budget Resolution. The President agreed to it. He went on television to endorse it. Congress enacted defense authorization and appropriation bills in accordance with that three-year budget plan. That is the current level of defense spending.

And it was NOT the figure from which the President extracted his $55 billion in defense restraint. Instead, the figure he used was the defense amount he proposed last February, before the Budget compromise. What the President is doing now is not much different from the store owner who advertises a "20 percent off" sale--after marking up the price of his goods 25 percent.

In this case, the President's $55 billion in defense "savings" actually amounts to an "increase" of $2.2 billion in FY 1984. Compared to the current $244 billion defense budget, the President's new budget would actually add $584 billion over the next five years. All other spending items in this year's budget are calculated from amounts following last year's cuts. For those programs, we are in round two. It's not even round one in defense.

If we are serious about reducing the deficit, we must do much better than that. Back in 1976 we passed a "turnaround budget" for defense, reversing the trend of real cuts and starting on a path of real increases in our defense capacity. We built steadily from two percent, to three percent, and recently to five percent real growth. We can accomplish quite a bit with five percent real growth. We can save $123 billion over the period 1984 to 1988. We can build a credible defense. We can avoid risking public support for the necessary defense buildup by not overdoing here while everyone else is expected to sacrifice. And we can make it clear that we won't have a strong defense unless our economy is strong enough to build it.

There's no shortage of large issues in the Fiscal 1984 budget. We have large questions to answer about entitlement programs, about social security, about the roads and bridges of this country. While each of those separate issues must be addressed, the larger question that we cannot avoid is fairness.

The Congressional Budget Office calculated the effects of the first two rounds of the Reagan program and found:

- Each household with incomes below $10,000 annually lost $320.
- The average taxpayer with an annual income between $20,000 and $40,000 gained only $710 each.
- But households with annual incomes over $80,000 annually gained an average of $14,200 each.

This budget does not address these inequities. Over half the proposed changes increase excise and payroll taxes which fall most dramatically on the lower and middle classes households. The program cuts for low income people are not as drastic as I had expected, but at $2 billion a year, they are significant.

No budget is easy to put together. It takes a lot effort from everyone. But if we are going to have economic recovery, much will be asked of many people. The people should expect no less from the White House and Congress.

Chairman DOMENICI. I failed to mention in my opening remarks, and I apologize, Senator Chiles, how delighted I am that you have assumed the leadership on your side. And I say that even after your statement.

Does somebody else want to speak on this side?

OPENING STATEMENT OF SENATOR SYMMS

Senator SYMMS. Mr. Chairman, I will be very, very brief.

I wish only to say, and I have expressed this to the Director, and I welcome you here this morning, Mr. Stockman, but I really do believe when you look at this budget and see that the advocacy is coming from the administration to the Congress to spend $2 billion a day approximately, and then borrow another half a billion on top of it every day, and then look back at what happened in history—when Franklin Roosevelt was President of this country, he actually came into Congress with a 25-percent pay cut for all Federal employees, and now some of us advocate that we should stop increasing the COLA's until we can get on top of this because everyone knows who studies budgets that the problem is built-in growth of the entitlement programs. Yet everyone in this town seems to be afraid to address the real issue.

CUT GOVERNMENT SPENDING

In my opinion, if we want to take care of these unemployed people, and I share the concern of Senator Chiles on unemployed people, the way to get them back to work is to have the Congress tackle the entitlements and stop increasing all these retirement benefits, all the welfare programs, all Goverment pay, including military, until we have this budget under control and the financial markets are convinced that we are on top of the growth of Government spending. We are not convinced of it now because I think that unemployment and interest rates are directly linked together.

So we have, in my opinion, the worst of both worlds with this budget. You know, we are getting credit for making cuts but the real cuts that need to be made are not being made.

I talked, and I will say this—I talked with a news reporter, a political writer in one of the newspapers in my State who is a lifelong Democrat, I might say, for my colleagues on that side of the aisle, and he said to me what is the matter with you people, why do you not cut my social security? He said all you are advocating is not increasing it. Why do you not cut it? What is the matter with the people in Washington, Democrats and Republicans? You people are in 7 square miles of the United States that is surrounded by reality, and he said I am out in Idaho Falls, Idaho. You are spending too much money. Everybody seems to know it but you here in Washington.

If we do not tackle this budget, we will not take care of these unemployed people. We ought to be talking about no increases for anybody that gets a Government check until we get control of the budget. That is the position that I wish our President would start from. Then there might have to be some compromise along the way. But if when he talks about a bipartisan budget and we have to give everything up before we start, it seems to me like it is a disaster, Mr. Chairman, in my opinion, of what his people outlined here, to be talking about a $200 billion deficit budget and really little minuscule adjustments in the budget.

Why is it that 50 years ago a Congress could cut spending 25 percent, and today if we talk about not increasing it, people say you are insensitive to human concerns. I think the way it is going to work out is we want to do something for the people out there, we better get control of this budget, and this is not a good enough document in my opinion.

Thank you.

Chairman DOMENICI. Thank you.

Senator SYMMS. Put me down as undecided.

Chairman DOMENICI. We will put you down as a $580 billion deficit reduction in 5 years is not adequate.

Senator SYMMS. That is correct.

Chairman DOMENICI. Do we want to go down the list?

Senator Metzenbaum.

Senator METZENBAUM. I will yield on the basis of seniority.

Chairman DOMENICI. Consistent with the idea that you will be brief.

OPENING STATEMENT OF SENATOR BIDEN

Senator BIDEN. I am always brief when there is not much to talk about.

What I would like to point out to my colleague from Idaho, it did not take the President in 1932 long to figure that the original proposal was wrong and change it.

By way of an opening statement, obviously we are all concerned about the bad economic times, and I should point out for the record it has transcended administrations. They were not real good when my guy was in, and I do not think they are real good right now, and I really think if we spend our time, we Democrats, talking about how much worse this guy is than the last guy, and you in turn talk about how all of what has happened now is because of the last guy, we are not going to get very far. And I am not suggesting you have done that, Mr. Stockman, but in the past we have had a President—he said in the state of the Union that he wants it to be bipartisan and seek our support, but in the next line he said that, by the way, we inherited all of this. All of this is a waste of time. We have been waiting 2 years for the Reagan administration to balance the budget, and you have now told us on three occasions the economy is about to surge, but twice you have come back to tell us, as most other economists, that you are wrong.

As a result of everyone being wrong twice, and I am emphasizing again the last President also being wrong several times in a row, we end up with the following circumstance in broad strokes. First of all, there has been a fantastic loss of national wealth. Comparing your original 1981 estimate for GNP, now GNP will be half a trillion dollars lower in 1984 than projected when you first came in. Interest payments on Government borrowing in the budget have soared. In 1988 interest payments will be $134 billion or 2.7 percent of GNP.

And other entitlement programs, which are often blamed, as you just heard, for the budget problems, will only be 2.5 percent. So the interest on the debt will exceed the entitlement payments as a percentage of GNP.

Unemployment is supposed to fall from 10.4 percent over this next 6-year period to 6.2 percent, and the claim of the administration is that means 15 million people will have jobs. But that is barely enough to put people back to work, let alone providing additional jobs.

And lastly deficits themselves will have soared by $790 billion in 5 years, virtually drying up savings.

So the whole process seems circular and, again, it started with my guy, it started with the Democrats, it started with President Carter, for the sake of discussion. But it is very circular.

Here we have bad economic projections. In two administrations in a row we have a bad economy that created deficits, deficits that then restrain economic recovery, a lagging economy that creates more deficits and so on. We are in a circular pattern.

My only statement, and I will conclude with this, Mr. Chairman, is that I think it is time we talk about a totally new economic program and not on staying the course or like we Democrats have been talking about because we were timid last year, saying we really like what he is doing but we just want to alter the course. I think it is time for a flat out, new economic approach. During the question and answer period, I hope to at least explore what I think are the directions we ought to be going in. I think it is that fundamental. Democrats do not have the answer. Republicans do not have the answer. And if we talk about how the other party does not have the answer, we will end up in this quagmire for the indefinite future.

Thank you, Mr. Chairman.

Chairman DOMENICI. That sounded very bipartisan.

Senator Johnston?

OPENING STATEMENT OF SENATOR JOHNSTON

Senator JOHNSTON. I would like to join my colleague and offer to do this thing on a bipartisan basis. But the first step to bipartisanship is a little honesty, and I must say I heard the President's speech the other night and it was absolutely breathtaking in the error which he promulgated. For him to say that defense increases, $584 billion, over the next 5 years do not contribute to the deficit, or that tax increases, three-quarters of a trillion dollars over the next 5 years, with indexing on top of that, do not contribute——

Chairman DOMENICI. You meant decreases?

Senator JOHNSTON. Tax decreases. It's utter and complete nonsense. If that is Reaganomics, and I am afraid it is, it is like the discovery in the Wizard of Oz, the movie, where the Wizard was behind the screen cranking out the phony machine and it was not real.

Well, this is not real. When you look at the figures, they just do not exist.

Now, a $189 billion deficit after these cuts in child nutrition, in educational assistance for poor children in jobs and training programs, and in women and infants and children nutrition programs—after all those painful cuts, to come up with a $189 billion deficit on the way to a balanced budget never, by a President who about 50 years ago invented the balanced budget, is simply unacceptable.

Now, I happen to be, Mr. Stockman, one of your supporters. I am not one of your detractors. I really mean that. I think that you recognize all this nonsense for what it is, and I think you have told them this all along, and I think you are still telling them what needs to be done to get this $189 billion deficit down. One of these days I think you will probably go public, other than in just one magazine, and really give us some leadership. And I am ready to follow because I know you know better. When that plan is promulgated, I am ready to follow. I am ready to follow you on eliminating the third year of the tax cut, on eliminating indexing, on cutting back the obsolescent B-1 bomber. Sure, I was with a lot of the people back in 1977 supporting the plane before something better was invented. But that plane is so far obsolete now—would you want to fly that through the Russian radar defense? No, no.

I saw in the Wall Street Journal yesterday where defense contracts are being let out all over the country, for over $200 billion, and that the military industrial complex momentum is growing. It is going to be hard to stop it.

We will have too much money invested in bad weapon systems at too high a cost which the President does not think increases the deficit, but you know better and I know better.

I say let us join together. I will join you in some cuts, reasonable cuts, balanced cuts, but let us not cut child nutrition by 22 percent and on down the line. Let us have some balance in this. I will join you, and I think you will get a lot of support on this side of the aisle.

Thank you, Mr. Chairman.

Chairman **Domenici**. Thank you.

Senator Sasser.

OPENING STATEMENT OF SENATOR SASSER

Senator **Sasser**. Thank you, Mr. Chairman.

I want to follow on the remarks made by Senator Johnston. First, I think we—to be honest, we have got to regard this budget as a marked failure of the President's economic program. We were promised a balanced budget by 1984 if we supported his proposed tax cuts and spending cuts in 1981, and we did that. Now we are faced with an additional budget deficit, counting off budget items of $1.7 trillion between now and 1988.

If the Reagan economic program stays the course, we are recommending additional budget deficits and additional national debt of $701 billion.

Now, when we first heard about surprise side economics, and frankly I never heard of surprise side economics until early in 1981 when we started talking about that, and Mr. Stockman was up here testifying, we were predicting and he was predicting unemployment would be at 6.5 pecent in 1983, 6.3 percent in 1984. We find that unemployment is going to be at least 10.4 percent in 1983 and at least 9.5 percent in 1984.

So before we start basking here in the rosy glow of coming up with a bipartisan solution to our country's economic problems, I think we need to face some facts. It is interesting how bipartisan we are getting now. I do not recall many of us on this side of the aisle being taken into the confidence of this administration for the takeoff. But now it looks like we are coming in for a crash landing and the engines are burning and exploding. We are being invited into the cockpit to assist in trying to get the landing gear down.

Well, I think it is also, to be honest about it—I think the American people ought to know that this 1984 budget is not one of shared sacrifice. It continues to be unfair. We have defense spending growing by 10.4 percent real growth in 1984, and we see no proposals in this budget for stretchout, major weapon systems. There is no admission that perhaps we cannot fully afford all of the weapon systems under construction and there is no suggestion at all that we can afford the various and sundry provisions of the 1981 tax cut, no matter how much they aggravate the budget deficit.

Well, this administration wants to be bipartisan, but this President says, under no circumstances is he going to entertain any cuts in the Kemp-Roth tax cut that went into effect in 1981. Well, that is inflexibility. It is unfair and that is not bipartisanship.

Well, Mr. Chairman, I hope that this committee can fashion a truly bipartisan budget that will bring down deficits, that will bring down interest rates, and one that insures that all parts of our society will make fair and genuine economic sacrifices in an effort to bring a long lasting economic recovery.

Chairman DOMENICI. Thank you, Senator Sasser.

Anyone on our side want to speak?

Senator Grassley?

OPENING STATEMENT OF SENATOR GRASSLEY

Senator GRASSLEY. Mr. Chairman, I wish I could say some of the funny things that have been said around here, too, but I guess I am always too serious about the things that confront the Congress and the things of substance I suppose ought to be said about whether or not I agree with the President on the defense budget, and I think that we ought to spend more and to compliment him for his attack on entitlements for the first time, which is badly needed. Those things I will have to let wait until we reach a point where we are dealing with the specifics of the budget in the markup session.

But I have my plans and I will be presenting them.

I do want to compliment the President for stepping forward and attacking entitlements for the first time. If we had done that my first 2 years, we would not be in the situation we are in now. I cannot compliment him for what he has done on the defense budget because I think we have to cut for the defense budget, but I am not so sure that the substance of what we are dealing with is as important as when we are going to make such tough decisions and how soon they are going to make them.

This budget did not get up any sooner than the law required, and maybe that is all we can expect from the President. But unless we do something very dramatic very soon, we are not going to be making these budget decisions until June or July, and this economy is dangerously cool and we have got a red hot budget that is out of control and we have got people in the private sector that are waiting for the leaders of this country and our President announced that Government has got to show a lead.

GOVERNMENT HAS TO LEAD

I hope we in the Congress believe that Government has got to make a lead as well and make some decisions or not make them on the basis of procedure in this Congress that has existed for the last 100 years of where we do not have to be in a hurry to make appropriation decisions. We have a series of hearings laid out in this committee that I raised with the chairman in private, whether or not we ought to have 2 months of hearings before we make some decisions and I have asked the chairman to either compact or eliminate some of the hearings so that this committee and this Congress and hopefully with the support of the President, and even hopefully with the urging of the President, that we will make some very early budget decisions and very dramatic budget decisions so that there is, early on, a signal sent to the private sector. But this is not a Congress as usual approach to making the decisions, and even though the substance of what we are going to decide in this committee, the size of the deficit and all the specifics are important, quite frankly I do not think it is as important as we get out of the usual procedure that we have been in here, very casually and very slowly and not very deliberately making decisions and making those decisions very early and recognizing them as tough decisions and recognizing them as we are making a decision not just for those of us in the Congress, not just for the 24 percent of the economy that is in the Federal budget, but for the entire 100 percent of the economy, encouraging the private sector and the public sector to pull together.

Chairman DOMENICI. Thank you very much, Senator.

I would say to my good friend it was your suggestion, as you have precisely explained it here, that we act with dispatch commensurate with the nature of the problem. The schedule I will hand out, hopefully this afternoon, after I confer with the majority and minority leaders, would have hearings completed February 24. It would not even go into March. Markup would start the first work week of March and we would have 1 week for it. So we have set aside 1 week for the deliberations. I hope they will be serious and deliberative, and I thank you for your contribution. When you suggested that I took it up with other members and then with my good friend from Florida who in turn took it up with his members, and I thank you for that.

Senator GRASSLEY. I hope we will have the cooperation of the executive branch so we will be expediting and so that we do not get excuses from the various departments that they cannot furnish us with the information.

Chairman DOMENICI. I will soon get to Senator Hart, but let me say to you that is in the mill between CBO and OMB in terms of the number crunching aspect which takes a lot of time and a lot of manpower. They are cooperating. CBO is geared up to do as many assumptions and programs as we can feed to them. We cannot forget that if the House is on the same track, CBO is doing the same thing for the House. So it is very difficult. Having arrived at that, and I do not think the economic assumptions are going to be very far apart between the lead advisory groups. So I think we will start with that part. We may have a baseline problem and we will work it out.

Senator Hart.

OPENING STATEMENT OF SENATOR HART

Senator HART. Mr. Stockman, I am not a supporter of yours in 1983, nor was I in 1982, or 1981. You are articulating at least as well as, if not better, than the principal sponsors of the tax cut, the centerpiece of supply side economics back in 1977, 1978, and 1979, and the theories behind it.

Some of us did not believe those theories at that time and we believe now that we are seeing the consequences of those theories.

But in the spirit of working things out together, I believe what you are hearing, at least from this side, is that we will not take control of the Government aspects of this economy until the President and the Secretary of Defense are willing to concede that what is now almost one-third of the Federal budget—defense spending—is also Government spending. So long as the Executive of this country and his defense chief do not believe that defense dollars included in the phrase "Government spending," I do not think there is a lot of hope for a solution of the drastic nature that Senator Grassley suggests.

Now we can talk about governmental salaries and we can talk about entitlement programs and we ought. But in the process, we have to talk about that one-third of the budget of spending that is going for defense. And until your principals are prepared to do that, I do not think there is a lot of hope.

Thank you, Mr. Chairman.

Chairman DOMENICI. Senator Metzenbaum?

OPENING STATEMENT OF SENATOR METZENBAUM

Senator METZENBAUM. Mr. Stockman, two years ago you came before this committee and I said to you that I thought your budget was cruel, inhumane, unfair, and unjust. Frankly, Mr. Stockman, I do not have that kind of comment to make to you today because I do not believe you bear the direct responsibility for this budget. I believe the responsibility rests upon the President of the United States, much more so than it did perhaps 2 years ago.

BUDGET UNFAIR

I think this budget is the unfair budget and I think that it is not bipartisan. It was not created on a bipartisan basis and it certainly does not create the concerns, hopes and aspirations of those of who sit on this side of the aisle. It certainly is not a compromise budget because there is no element of compromise I can find. It is the budget that has the old Reagan priorities with new slogans. It is a budget that is unfair. Twelve million unemployed people in this country.

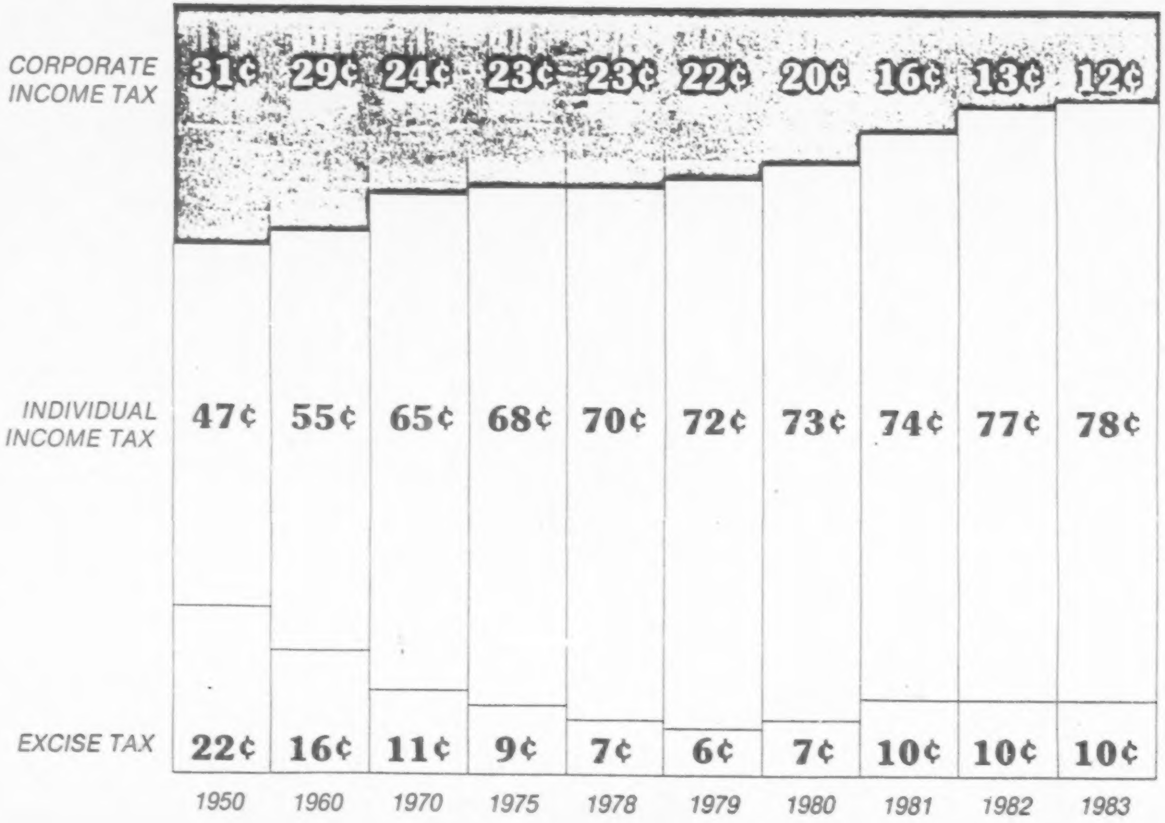
It is a budget that gives all the emphasis to defense spending, up $35 billion in 1984; $500 billion in 5 years, up 14 percent. That is not fair. It is not fair to the other programs that need funding and it is not fair to the Northeast and Midwestern part of this country because 80 percent of those additional defense dollars will go to the South and Southwest and the programs for the poor were cut 14 percent at the same time defense spending goes up 14 percent. Medicaid and food stamps and legal services and other things, down 14 percent. That is just not fair, not reasonable, and other people-oriented programs like education, student loans, medicare, aid to disadvantaged, school aid across the board are all hurt by this budget. Perhaps farmers are hurt the most and that is not fair.

TAXES

But in order to have a budget come into balance, you have to look at the revenue side as well as the expenditure side. The 1981-82 tax bill provided for almost $750 billion in tax cuts and as I sit here today, the Reagan programs have provided that each household income of $10,000 has lost $320 and each household income over $80,000 has gained $14,200.

Mr. Stockman, I say to you, on behalf of the President of the United States, that is not fair. That is not what it is all about and now when it comes time to be looking at what we ought to be doing about it, we see, quite evident from this chart, what has happened with respect to taxes. We see corporate income taxes have gone down some 31 cents out of a Federal tax dollar to 12 cents. Yet, we see that the individual income taxes have gone up from 47 cents of the tax dollar to 78 cents and it will go up even higher as we go into the out years and we see that excise taxes, which again are also paid very much by the individuals, have pretty much stayed about the same, up at 10 percent.

SOURCE OF FEDERAL REVENUE



What we see is an unfair shaping of the burden, pushing more and more on the individuals and less and less on the corporations of this country.

As you well know, if we are going to do anything about this whole issue, we are going to have to address ourselves to some of the tax cuts that were put into place in the 1981 and 1982 tax bill.

Now, as a matter of fact, in all fairness to you, you were quoted in the Atlantic Monthly article as indicating that you yourself had been an advocate of seeing to it that the tax burden be more fairly spread and closing of the tax loopholes. The figures that I talked to you about to this point have nothing to do with the tax loopholes on which I have addressed myself on previous occasions.

What I am talking about is the fact that you cut capital gains tax 60 percent in 5 years. The Democrats had part of the responsibility. We reduced it from 48 percent to 28 percent. The Reagan tax bill reduced it to 20 percent.

What does that mean? That means that those selling stocks are paying the same rate of tax as a family of four making $15,000 a year. You eliminated the estate taxes for all but three-tenths of 1 percent of all estates. That is not right and that is not fair. As a matter of fact, you have cut corporate taxes so much that 16 Republican Senators wrote a letter to the President of the United States in which they said, we are greatly concerned that by 1985 as many as half of all corporations may be paying no corporate income taxes. Said they to the President, it would be a mistake to allow such a situation at a time when all citizens should be asked to assume their fair share of that burden.

I might say, that 50 percent of the embers on that side of the aisle in this Budget Committee signed that very letter.

I say to you, if we are going to be fair, then we have to look not alone at what we have done in the past but we even have to look at what the President's new proposal is because the President has a standby proposal to do what, to add 12 cents a gallon to the people's gasoline tax or to add a surcharge or an additional tax upon the income of individuals. How unfair can you possibly be. How unreasonable can you possibly be. And I say to you, that we have to address ourselves to the revenue side and you know the answer is on the revenue side. I think that some of us on this side are prepared to work with you to try to do something about eliminating some of the inequities, some of the unfairness that exists in this budget but certainly in grading it, it does not represent any bipartisanship and it does not represent any compromise and when and if this administration, the President himself, indicates a willingness to compromise and work on a bipartisan basis in an effort to achieve a fair result, and I feel confident that most of us who are Democrats will be prepared to help him—but at this moment, all I can say is this is the unfair budget.

Thank you, Mr. Chairman.

Chairman **Domenici**. Senator Riegle.

OPENING STATEMENT OF SENATOR RIEGLE

Senator **Riegle**. I think a number of useful comments have been made by Members on both sides in terms of expressing the concern and skepticism that I think exists here in the Senate on both sides of the aisle.

REAGANOMICS HAS FAILED TO WORK

I would just like to make a few brief comments here. We have now in place I think an administration economic policy which everybody calls Reaganomics which has failed to work and I think the budget you have brought today is just one measure of the failure of Reaganomics to work and you can measure it by the unemployment projections. You can measure it by the deficit projections and other things that are implicit but not contained in the budget document itself; namely, the record bankruptcies and foreclosures taking place all across the country, the financial distress of State and local units of government sinking deeper and deeper into trouble. Our State of Michigan being one State. But if one reads what the Governors of New York and California and other States are doing, they are dealing with the financial crises of their own, in very substantial measure because of the failure of Reaganomics to work and to turn an economy around and get it on the uptake. Even the high interest rates are a measure of that and there is now some concern, and the market has been very squirmish in the last few days in light of the projected Treasury borrowings as to whether or not the easing of interest rates over a period of time, still at a very high plateau level, may be starting back up again, some evidence that it may be happening, God forbid that it should. We have a deepening worldwide recession, if not depression.

It was very interesting, last week in U.S. News & World Report, we had six Nobel Laureate economists giving their views and I am sure you probably read that set of views, and if not, I would urge you to do so, because in those views, which were all current, they were all able to say precisely how they read the situation and what their thoughts were for policy adjustments. Two of the six in very plain language describe our situation today as a worldwide depression. Those were the words they used. I think that is significant, that two of the six in this compilation would hold that view. Others, by the way, all argued for different policy changes of one kind or another.

Our home State of Michigan, as you may well know, the unemployment rate is 17.5 percent. This is 2 years down the road, so to speak, after you folks have had a chance to try to guide the direction of macroeconomic policy.

STAY THE COURSE BUDGET

I think the President's state of the Union message, as others have stated, gave the false impression that he was shifting the course and making some major adjustments to try to deal with these problems. But as we have gotten the budget documents and as Senator Chiles has said, as we have analyzed the budget documents, and we are still going through that process, it is obvious that this is a stay the course budget, that despite the tone and the phrasing of the President's speech, which I think was designed to create something of a feeling of a fresh start or a substantial modification of direction, the numbers do not bear that out. There is no substantial modification of direction and we are on the same course with a massive defense buildup, with an acceptance of continuing massive deficits, with an acceptance of continuing massive unemployment, stretching out as far as the eye can see into the future, additional deep cuts in Federal human service programs that are more necessary now because we have more people in difficulty in this country that need that help and, nevertheless, in program after program, additional deep cuts are proposed, ranging from energy assistance to the elderly, child nutrition, major cuts in medicare. I am told, for example, the analysis is not complete, but I am told, if your medicare cuts are implemented as you asked for them, as we get out into the future, a person with any medicare coverage that had a serious illness and had to go to the hospital would have to have something on the order of about $1,500 in additional hospital bills themselves but several thousand dollars in medical bills for doctor services which were not eliminated. So we would be looking at people in that situation having to bear an additional cost burden of something on the order of $5,000.

Well, you know and I know, in both your old district of Michigan and in this country, there are an awful lot of folks that do not have the financial strength to cope with those additional cuts and have had coverage that they have been depending on and using for a period of time.

KEY COMPONENTS OF BUDGET NEED TO BE CHANGED

I do not see how interest rates can drop to a workable level and stay there and others have expressed this concern, including the chairman, in terms of the problem with interest rates, until the economic policy mix is substantially changed and that means that the key components of the budget also have to be changed substantially.

I think it includes the following list of things and other things. I think we need a specific job initiative to try to deal with the massive problem of unemployment in this country. I think we have no choice. Major cuts in defense spending, those are not in here. We are going to have to make them. I do not think we can afford the further cuts in key human services.

We have no revenue action. I think we need to suspend the third year of the tax cut for the high-income people who are scheduled to get really an enormous windfall in the middle of this year and I think indexing falls into the same category. That would help us bring these deficits down in the out years and I think give us an interest rate picture that would lead to an economic recovery getting started. But I think at the same time, and there has been no mention of this by the President or yourself that I am aware of, and that is in exchange for the fiscal tightening which we need to make, we also have to have an understanding in terms of some monetary easing because if we do not get the two things together, we are not going to get the surge we need going on into the future that will put people to work and close the deficits.

PRESIDENT'S BUDGET LACKS SUPPORT

I might just say, in conclusion here, that I have not yet heard a single Senator say that they can support this package as it has been presented. I have not heard anybody here in this room today say that on either side of the aisle. I heard people file different caveats as to different things they are concerned about but it is apparent from what has been said, not just here today but public statements of other Members of the Senate that I have been able to see and read and hear, and for that matter, Members of the House as well, that there is not even the beginning of a basis of support for this package, either in terms of its macroeconomic components, its active or the lay of the detail in terms of the spending priorities and the direction that has been laid out here.

So we are going to have to rewrite this budget substantially. We are going to have to change it fundamentally. I hope that can be accomplished in a short period of time before more damage is done and more needless human suffering is inflicted on a number of people who do not get into this room but whose well being and the well being of other children depend on our competence and effectiveness in dealing with these issues. We have a responsibility to them that we have not yet discharged, to put this situation right and I am hopeful by changing it substantially we will be able to do that.

Thank you, Mr. Chairman.

Chairman DOMENICI. Senator Exon?

Senator EXON. Mr. Chairman, I assumed we were in questions. This is opening statement?

Chairman DOMENICI. We have changed this morning and let everybody have an opening statement.

Senator EXON. Can I have 2 minutes?

Chairman DOMENICI. Of course.

OPENING STATEMENT OF SENATOR EXON

Senator EXON. Thank you for coming again. I have been listening to the comments that have been made here. I am sorry I could not be here for all of it.

I heard the President yesterday go down to St. Louis and challenge others who did not agree with him to come up with a plan of their own.

I for one want to pledge to you, and I think I have exhibited that on certain occasions in the past—I do want to work in a nonpartisan way, but I would hope that as a key member of the administration, you could send a message back there that the votes are not going to be as easy to get in the U.S. Congress by the administration now as they were in the past. The President has—the President just might need the votes of some of us to put through some of the programs that we agree with him on. Others have said, and I want to repeat it, that a true bipartisan spirit is necessary but bipartisanship is a two-way street. I stand ready to assist you in any way I can. I do not believe we can work out the difficulties that this Nation is in economically and militarily unless we have some kind of consensus. It is up to the President and you high up in the administration to lead that effort as opposed to just espousing what sounds like good nonpartisan rhetoric.

That is all I have to say, Mr. Chairman.

COUNTRY NEEDS BUDGET RESOLUTION

Chairman **Domenici**. Let me say to the members of the committee that are here I assumed this leadership role this year with the firm commitment, as I hope all of you have, that this country desperately needs a budget resolution. I think from time to time there has been talk about whether it works, that it causes delay, that it is too complicated. But frankly I think if we are unable to come up with a blueprint that at least sets out where this country is going for the next 5 years, we will be sending the worst kind of signal possible to the millions of unemployed that have been spoken of and that I alluded to and to the millions of Americans who stand ready, anxiously waiting to get their confidence back so that we can act as normal consumers, so that the businessmen can respond in a normal way, investing again and buying things.

So I hope that you understand that I am committed to do that. I am committed to take our message as we proceed through the next 5 or 6 weeks in an effort to come up with a budget to the White House. There is need for compromise. A number of areas of potential compromise have been expressed here. I hope nobody has a budget specifically locked in concrete that they will support and nothing else.

I do not—I do have some general ideas, some trends, some goals, and I am going to work with all of you in an effort to achieve those goals.

Mr. Stockman, we have your statement that you have submitted for the record. It will be incorporated into the record and you may proceed as you wish.[1]

STATEMENT OF HON. DAVID A. STOCKMAN, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. **Stockman**. Thank you, Mr. Chairman.

I fear in yielding my time I have made a grave mistake. I once thought that partisanship would cause my eventual demise, at least a year or 2 ago, but after hearing Senator Johnston's discussion of my true opinions, I am beginning to think it might be bipartisanship that will eventually do me in.

I am sorry that Senator Biden is not still here. I did want to clarify something very important in terms of setting the record straight.

He took exception to the fact that we have often blamed some of the problems we are struggling with here on inherited problems of the past. What I mean by that is very specifically the economic and budget problems created over the 15 years prior to 1981. As I calculated it, that consisted of 8 years of us and 7 years of you.

So I think we would say in some basic sense that the responsibility is shared. The problem is here and we have got to find some way to cope with it.

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[1] See p. 33.

I had an extensive statement that I have already put in the record. I did have an abbreviated statement that I intended to give. The time has been consumed so let me take 4 minutes to answer some of the major points that I think are well taken, that this committee will have to deal with, but I am not sure the full perspective is reflected in some of the things that were being said here.

TAXES AND REVENUES

There was a consistent theme that the tax cuts are at the heart, the source of this whole problem, that somehow as we back up and look around in February 1983, that there is a huge revenue drought and that unless something major and sweeping is done about taxes and revenues, we are not going to get at the heart of this problem.

Now, I would just say to many of you who we worked with in 1981 to put the trillion dollar tax cut through and who we worked with in 1982 to modify part of the Tax Code and close some of the loopholes that Senator Metzenbaum has been telling us about and entered into with a net reduction of $750 million over 5 years in this budget, that that tax reduction is measured against the previous law or the prior law that was unindexed, that had a great amount of bracket creep in it already and a system of corporate depreciation that everybody on this committee was against that was in Congress in 1980 because you were all introducing one bill or another in order to stimulate capital investment in order to correct that problem.

But if you look at this budget, and you keep that in mind, you will see that we have proposed in here $233 billion in additional revenue above current law for the 5 years in this budget. If the standby triggers in and under any reasonable historic path for the economy it is likely to, and if you include that proposal of $233 billion of revenue over the 5 years between the social security taxes that we have agreed to, between the health cap that we have to have for policy reasons but has a revenue impact, and this standby measure, however, you think it might best be done, what we are talking about is a system that will generate 20.6 percent of GNP in revenue in 1988, and that is only a hair, that is only a fraction lower than the tax burden that we faced in 1981 when we started, 20.9 percent of GNP.

So some of you who reject this budget because we have ignored the revenue issue or some of you have said that deficit is still too big at $117 billion in 1988, who feel that domestic cuts are far too big and that we need to do revenue instead of domestic cuts, I hope you will think about the implication of what you are saying.

You are saying basically that in 1981 an economy that was staggering under inflation and no growth and declining productivity and inadequate investment and the lowest savings rate in history and the lowest savings rate in the industrial world was not being taxed enough because this budget taxes the economy with the standby at the same level that was being taken in 1981 that what you want to do is solve this fiscal problem by, in the outyears, or the near years, or however you stage it, raising the tax burden even beyond where it was before anybody heard of Kemp-Roth or the 1981 tax bill or anything we have done subsequently. I do not know that you really want to do that. I do not think that that is the answer. But that is the implication of what has been said here today if you are implying that vast new revenues beyond what are in this budget are required and I hope that you will take that into account.

RECOGNITION OF KEY CONGRESSIONAL PRIORITIES

Now, second, there have been a lot of points made that this really is not bipartisan because there are cuts in this budget for certain small discretionary programs that many members of this committee or the Congress feel are important. I think somebody mentioned vocational education, somebody else WIN, somebody else the breakfast nutrition program. But as we put this together, recognizing the gravity of the problem and the critical need to find a way to collectively work and pass laws that will close this deficit in the outyears so that this economy can recover and so that jobs can be provided, we recognize how strongly many of you feel about some of these programs that we have tried to cut in the past, for good and sound reasons in our view, but for reasons that you did not find persuasive and rejected it.

So I made a special point of dropping every one of those cuts in this budget as well-grounded as they were from our vantage point, as part of an effort to demonstrate to this Congress that we want to work with you, that we are not going to create unnecessary operation and conflict over small matters. And if you will look at page 18 of my prepared statement,[1] you will see a list of programs, including those that you feel strongly about, handicapped education, education for the disadvantaged, women and infant and children feeding programs, impact need, implement and training, child welfare and foster care, social services block grants, in which we asked for $11 billion last year and you appropriated $16 billion because you disagreed with our priorities and our cuts.

What did I do in this budget, what did I recommend? I recommended that we ask $16 billion for these programs in 1984. You will see them on the chart, exactly what you appropriated in 1983, as a gesture of accommodation and recognition that there are some things that you want to see funded, some programs that you want to see supported that are not worth arguing over in terms of the friction they create and the conflict they create.

I have not heard one word this morning of acknowledgment of many of these cuts that we have proposed in the past that we did not pursue again, as part of an effort to work with the Congress and as part of an effort to recognize your priorities.

Instead, what you have done is put your staff to work to find something in this trillion dollar budget, no matter how small and insignificant, that you can bring up here and criticize and complain, without even asking the reasons for.

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[1] See p. 51.

EDUCATION

Now, the fact is that we have appropriated almost every—requested almost everything for education that you appropriated in 1983, except for one program, vocational education. The reason for that is that State governments and school districts fund 90 percent of the cost of good vocational systems we have in this country, and we decided, facing a $200 billion deficit, that a couple hundred million could come out of that. That is the only education program we cut. We have not cut higher education. There is a small change in the guaranteed student loan program. By the way, the reason it is down is interest rates are down and the costs of servicing that $30 billion are down because of the interest rates. We did not cut anything. In the rest of the education budget, from handicapped education to education for the disadvantaged, to the whole Pell grant higher education program, we put in the same amount of money that Congress puts in, and far in excess of our request last year. I have not heard a lot of words about that. I heard a lot of nitpicking. I think that ought to be clear.

Senator HART. Wait a minute.

Mr. STOCKMAN. You will get a chance——

Senator HART. Mr. Stockman is lecturing this committee and I want to make a point. The President of the United States told the Congress what he would accept and what he would not. I do not happen to be one of those people he is talking about here, about what we appropriated and what we did not, but we all know that we were operating under a threat of a Presidential veto. So I do not think this foisting off of what we did——

Mr. STOCKMAN. I am sure there will be chance for questions but I would say to Mr. Hart that in that budget you froze discretionary programs and the Appropriations Committee then worked within that envelope to produce the funding levels for all these programs I mentioned.

We have asked for the same levels almost uniformly again and that is my basic point. Sure, there will be others we can disagree about, but what I am arguing is there are only a few hundred million dollars, a few billion dollars that we are talking about, and we are faced with a $100 billion deficit in 1 year and a trillion dollar problem over time.

DEFENSE

Now, the third problem I wanted to make is next to revenue we have heard that defense is the sum and substance of the problem that we face. I recognize that there is going to be arguments about the precise increase for this year, about weapons systems, about how rapidly the buildup ought to be and so forth. But let me put something else in perspective. In 1981, we all agreed that defense had been drastically underfunded. Pay was atrocious. Readiness was at a deplorable state. We had serious problems in the long term in writing the strategic balance and we had done almost nothing in the last decade in terms of modernization of our weapons systems and land vehicles and so forth. And this Congress agreed almost overwhelmingly that more money and substantially more money had to go into defense. So we asked for $12 billion in a supplemental in 1981 and it passed overwhelmingly with votes on both sides of the aisle.

Then in 1982 we asked for another large increase to continue the readiness effort and to continue the modernization program that has only been started or suggested in 1981. And the Congress agreed to a $35 billion increase in 1982 over 1981 for defense, to begin to make well and remedy many of these programs that had accumulated in the late 1970's.

Then, last year, we got into more of a difference of opinion and more heated debate in the Appropriations Committees, the budget process and the floor of the House, but when all was said and done, you increased another $25 billion beyond the $35 billion and the $12 billion before that in order to continue to pursue the basic objectives that we agreed to.

Now, what this says to me is that there is a very broad consensus that a lot of things had to be done that cost money and that Congress has been supporting doing those things for 3 years. The reason the budget goes up for defense in 1984 is that it reflects the costs primarily of all of those things that we have started and that you have agreed to over the past 3 years. That is what that increase is in the budget. There is very little of that $35 billion that is for new starts, new programs, things that have not been started before, started in R&D or readiness initiatives that were not launched last year and will need more money this year.

When we have this defense debate, let us have a good one and if you can find things that you can persuade the administration are not needed, I am sure people will listen. But let us not imply that this whole $200 billion dollar problem is due to a defense budget provided in 1984 that came from out of the blue and that does not represent things that, in the main, 90 percent of all of you have supported in the last 3 years.

I might also say that we heard about a 10-percent real increase for defense and a 3-percent real reduction for nondefense and how is that fair. Well, I think all of us, especially the members of this Budget Committee, who know more about the dynamics of this process than anybody else, recognize that a budget does not begin and end in 1 year, that we have looked at things over time, trends, given the enormous momentum or given the programs, defense, and nondefense alike.

What we are recommending in 1984 represents a 5-percent increase in real defense spending from what this country spent in 1970, a 5-percent increase only after you discount for inflation when you look at this in real dollars, and a COLA, nondefense budget of $500 billion represents a 95-percent increase after inflation for nondefense programs from the WIN to social security, all the way through all of the other individual projects that many of you think are important. Ninety-five percent more in real terms over 14 years for our domestic needs, 5 percent more for our national security needs, and it is being implied that something is way out of balance, something is drastically wrong.

What I want to suggest this morning is there is nothing way out of balance, nothing drastically wrong. There is a channel. There is an area for hard and tough argument, for serious scrutiny in the defense budget, but it is not the solution to the problem of this deficit any more than revenues alone are.

NO SIMPLE KEY CALLED TAX REFORM OR DEFENSE CUTS

Finally, let me say that we have all implied that somehow we have come to the end of the line on domestic spending but we know the heart of the problem is the COLA's. We know in 1984 there is $323 billion in this budget for transfer payments, excluding the means tested entitlements. That will grow by $228 billion over the next 5 years under current law unless we do something about COLAs, unless we do something about a rate of increase in medicare and medicaid that is 3 to 4 times the inflation rate today. We again can argue about the precise mechanisms but unless we acknowledge that as part of the problem as well as our arguments about defense, as well as the need for revenues that may exist and that have been acknowledged in this budget, I do not think we will have a framework for bipartisan cooperation either because we will not be dealing with the real facts. We will not be dealing with the real dilemmas, binds and tradeoffs that we find ourselves in in this country today for reasons that go back 15 years, for reasons that reach to both branches and both parties and to a lot of things that we have tried to do that we could not do or things that we now can no longer afford.

So I would make that statement, not to be provocative necessarily, not to get into an argument with anyone on a particular program, but to suggest that this is a very big problem and there is no simple key called tax reform or defense cuts that is going to solve it. We have to look at the thing and I hope we can do that together.

Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you very much, Mr. Stockman.

TESTIMONY OF
THE HONORABLE DAVID A. STOCKMAN
DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET
BEFORE THE JOINT ECONOMIC COMMITTEE

PART I — BUDGET TOTALS — PRESIDENT'S BUDGET FREEZE AND REFORM PLAN

BUDGET TOTALS AT A GLANCE

	1983	1984	1985	1986	1987	1988
OUTLAYS . . .	805	848	919	990	1,058	1,127
RECEIPTS . . .	597	660	724	842	916	1,010
DEFICIT	208	189	194	148	142	117

HIGHLIGHTS

- PRESIDENT'S BUDGET FREEZE AND REFORM PLAN RESULTS IN NO REAL GROWTH IN 1984 BUDGET
- REDUCES DEFICIT BY $43 BILLION IN 1984 AND $558 BILLION OVER 1984-88
- MAINTAINS ESSENTIAL DEFENSE BUILD-UP AT $55 BILLION LOWER 5-YEAR COST
- CAUSES DEFICIT SHARE OF GNP TO STEADILY DROP—KEEPING BUDGET ON A PATH CONSISTENT WITH SUSTAINED ECONOMIC RECOVERY

1983	1985	1988
6.5%	5.1%	2.4%

FOUR-POINT BUDGET FREEZE AND REFORM PLAN

1) 1984 Spending Freeze Measures

- No increase in civilian/military pay and retirement.
- 6-month COLA freeze for Social Security and related indexed benefits.
- Freeze on aggregate non-defense discretionary programs, medical provider reimbursement and farm price supports.

2) Long-term Structural Reform

- Bipartisan Social Security Solvency Plan which cuts $79 billion from 1984-88 budget deficit.
- Health care reform and efficiency incentive package involving $58 billion in 5-year savings from Medicare/Medicaid and private health insurance cap.
- Major reforms of civil service retirement, better targeting of means-tested entitlements and veterans benefits.

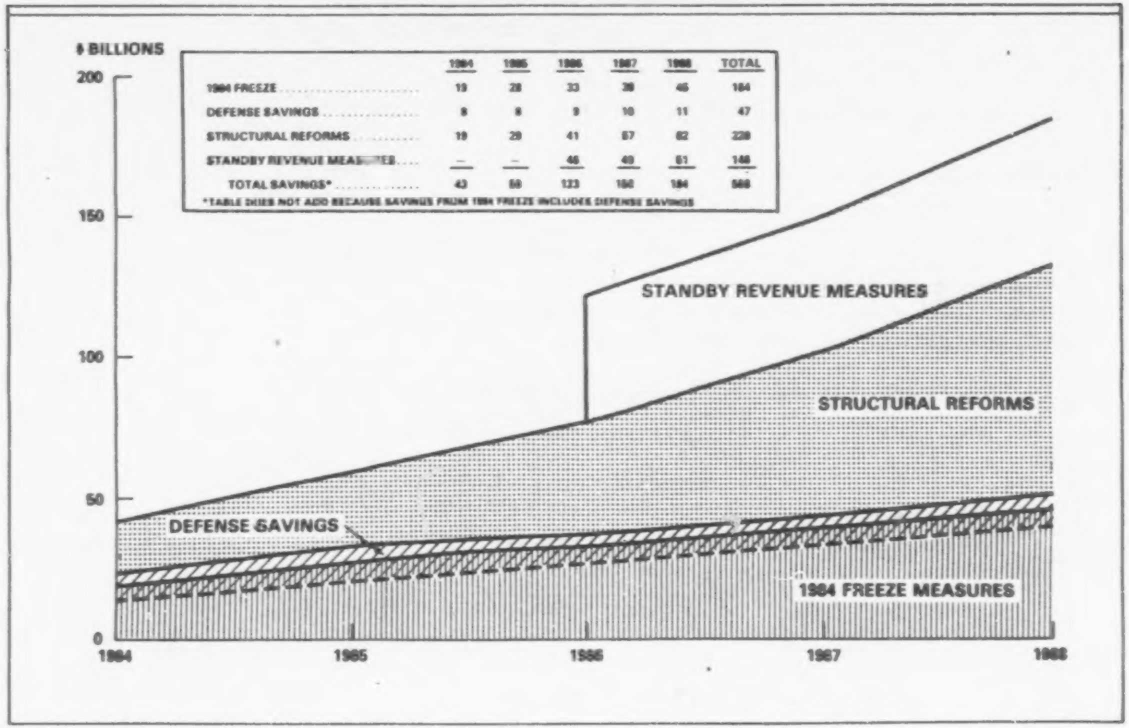
3) Maintenance of Defense Build-up at Lower Cost

- $55 billion in pay, fuel and inflation and program economies and savings over 5 years.
- Fully protects strategic programs, readiness and sustainability initiatives and conventional forces modernization.

4) Deficit Insurance Policy

- Standby tax equal to 1% of corporate and individual taxable income and $5 per barrel oil excise tax.
- Triggered in FY 1986-88 only if budget freeze and spending reforms adopted, deficit above 2.5% of GNP, and economy in recovery.

FOUR-POINT BUDGET FREEZE AND REFORM PLAN AT A GLANCE

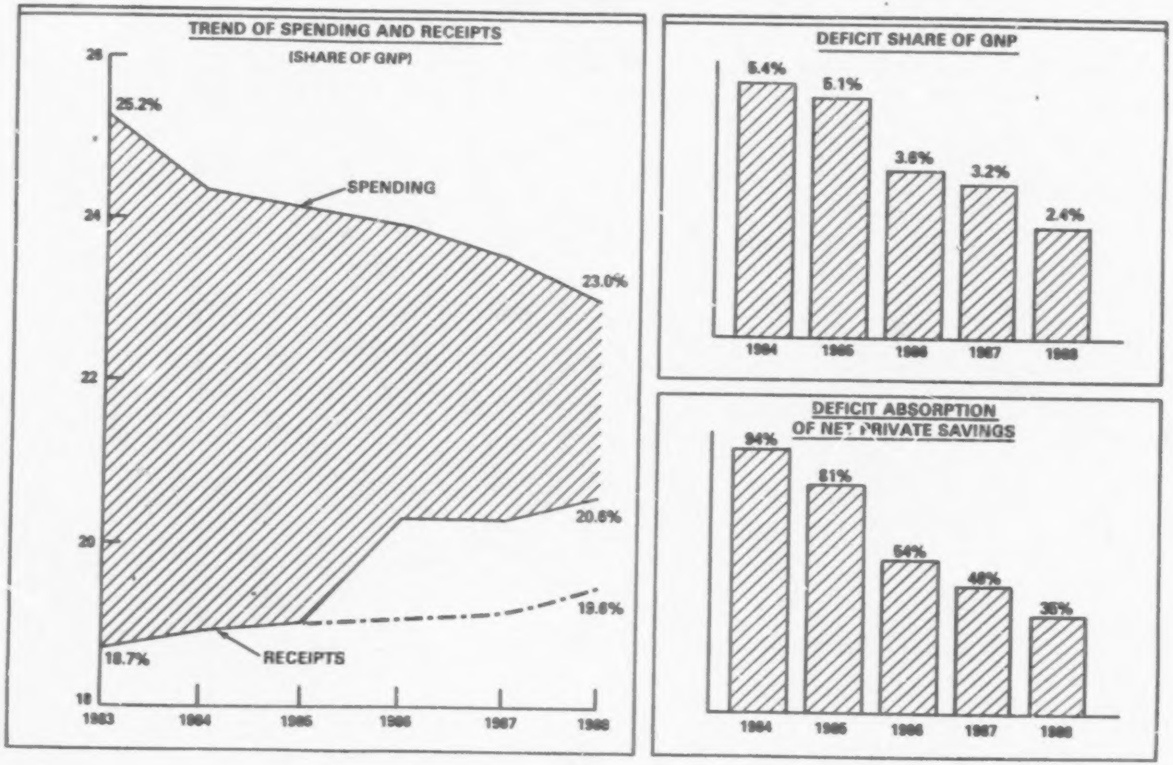


	1984	1985	1986	1987	1988	TOTAL
1984 FREEZE	19	28	33	39	45	164
DEFENSE SAVINGS	8	9	9	10	11	47
STRUCTURAL REFORMS	19	29	41	57	82	228
STANDBY REVENUE MEASURES	—	—	46	49	51	146
TOTAL SAVINGS*	43	58	123	150	184	558

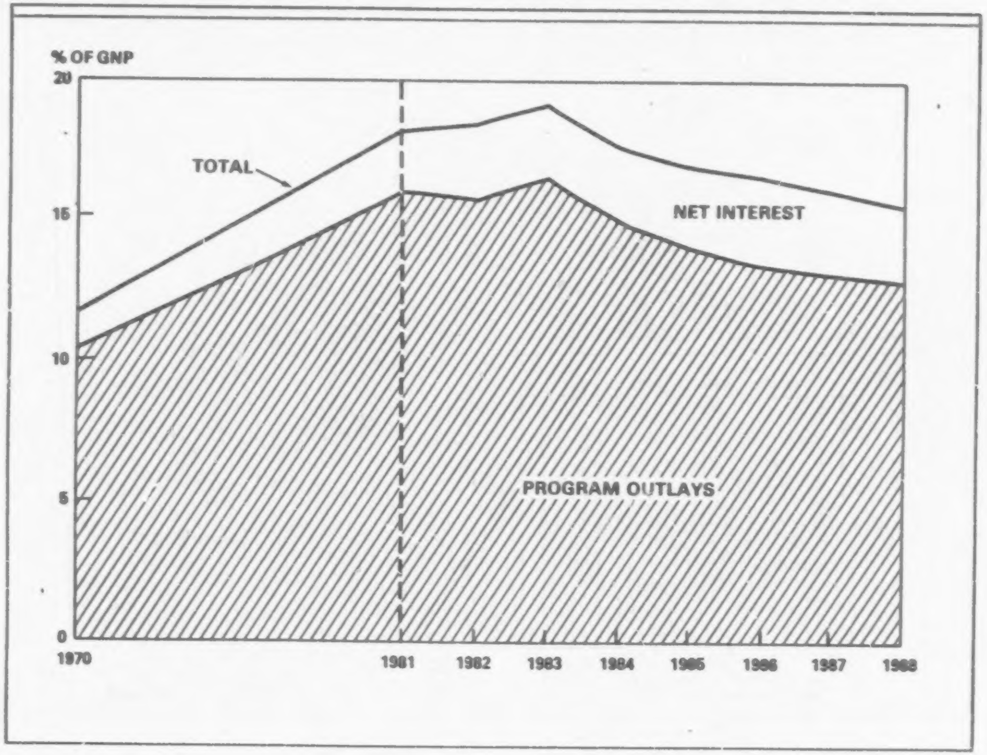
*TABLE DOES NOT ADD BECAUSE SAVINGS FROM 1984 FREEZE INCLUDES DEFENSE SAVINGS

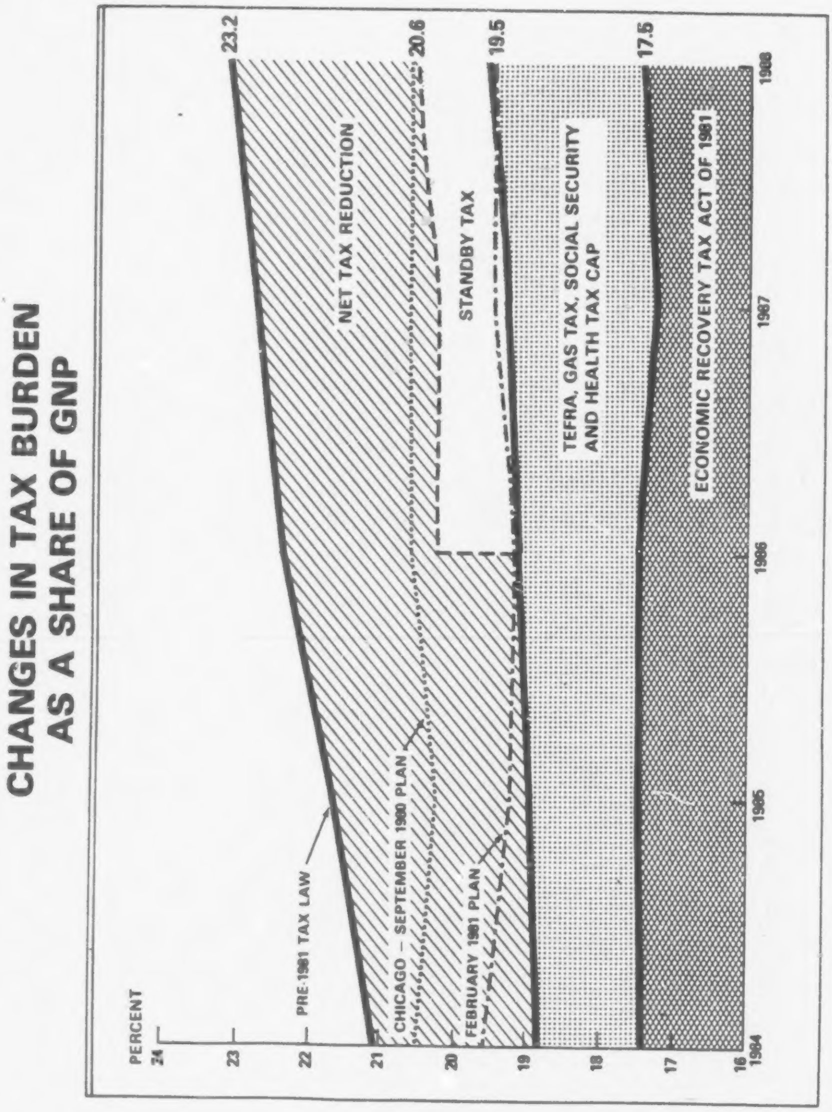
FISCAL ECONOMIC IMPACT AT A GLANCE

(SHARES OF GNP)



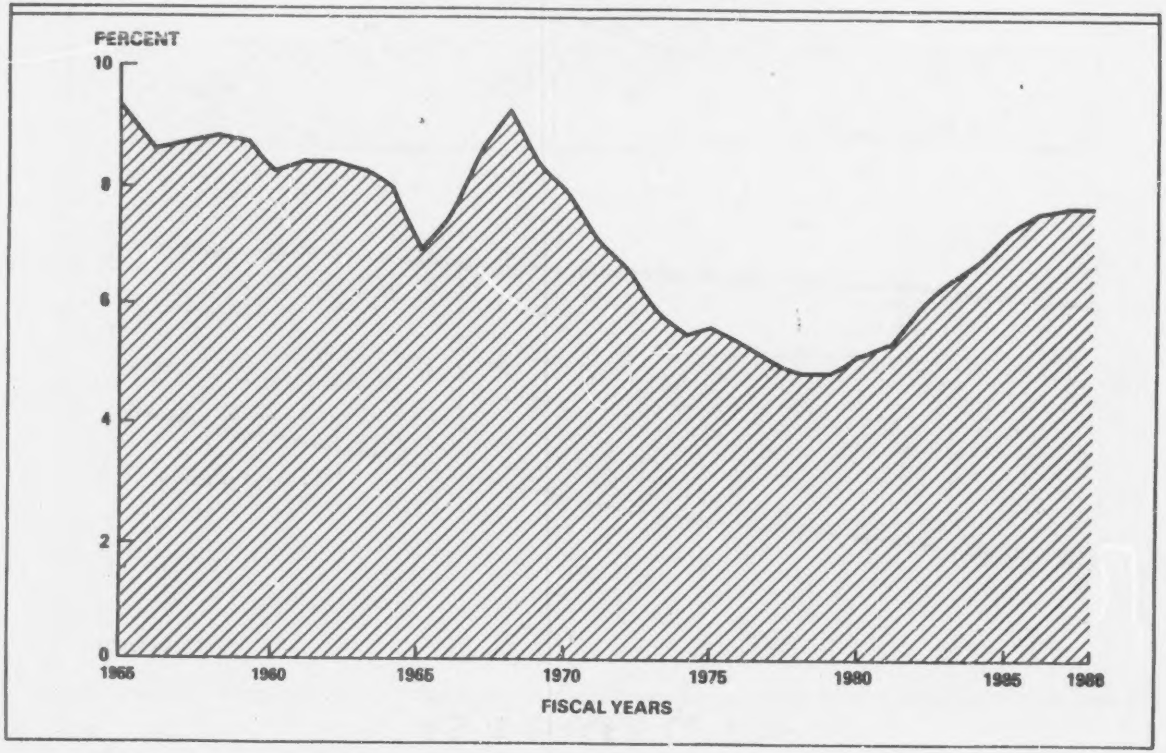
NON-DEFENSE SPENDING AS SHARE OF GNP





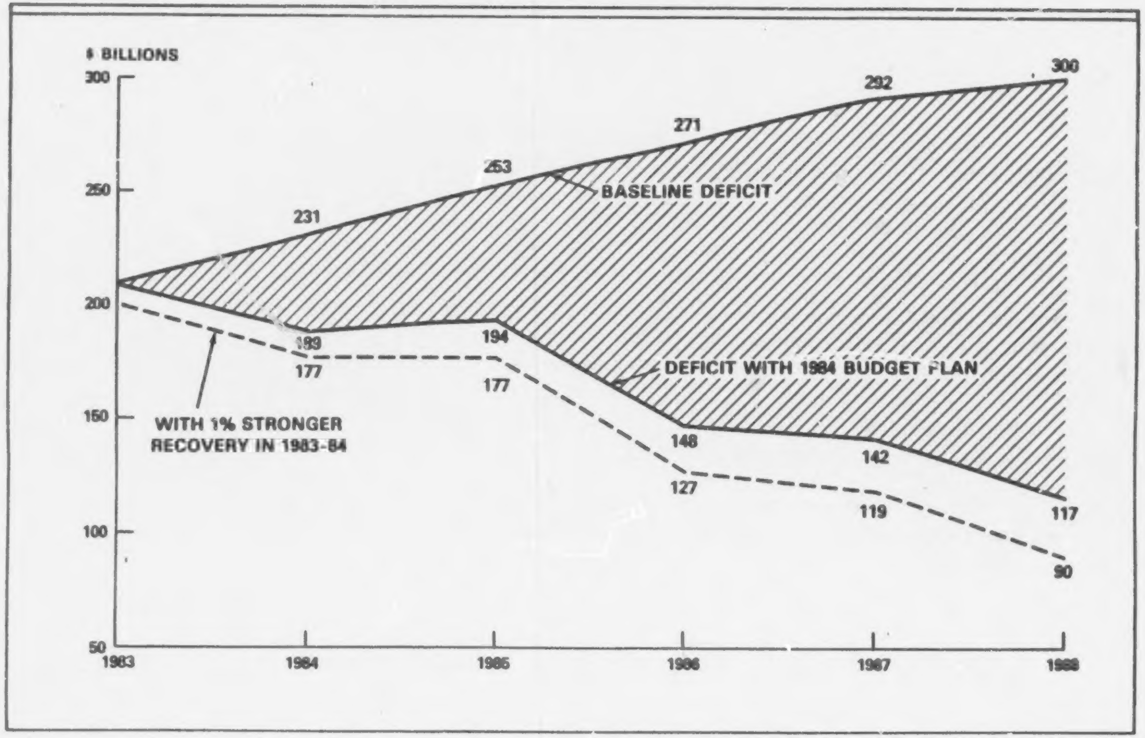
CHANGES IN TAX BURDEN AS A SHARE OF GNP

DEFENSE OUTLAYS AS A SHARE OF GNP



PART II — SOURCE OF THE STRUCTURAL DEFICIT

DEFICIT OUTLOOK AT A GLANCE: BASELINE VS. 1984 BUDGET PLAN

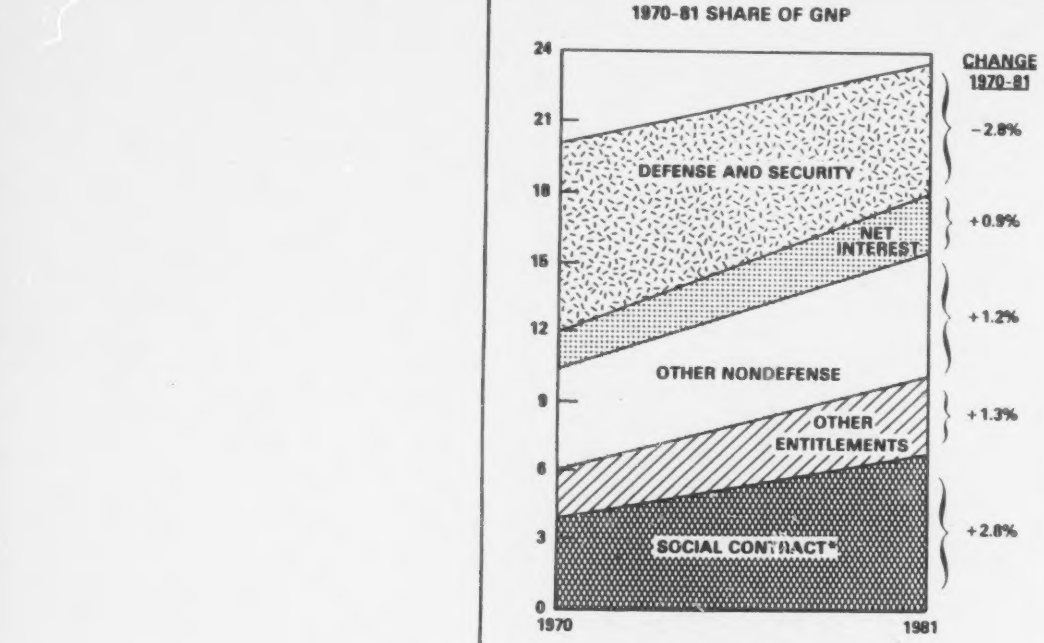


SOURCES OF THE STRUCTURAL DEFICIT

- The baseline deficit totals $1,347 billion over 1984-1988 and averages more than 6.5% of GNP — posing a serious threat to sustained economic recovery.

- Most of the out-year baseline deficit is "structural" representing the cumulative impact of 15 years of fiscal policy developments and economic trends. The three primary contributing forces are:
  - The doubling of constant dollar domestic spending from 1970-1981. This increased the cost of transfer payments and discretionary programs from 10¢ to 16¢ on every dollar of GNP — three-fifths of which was locked into automatic entitlements.
  - The prolonged economic adjustment of 1981-83 due to the unwinding of the 1970's inflationary disorder built into the national economy. This abrupt, severe disinflation process has dramatically lowered the long-term path of GNP and revenues and added enormous permanent debt service costs to the budget.
  - Failure during the first two budget cycles to restrain indexed benefit growth and significantly reform the big medical and retirement entitlement programs.

INHERITED FISCAL IMBALANCE

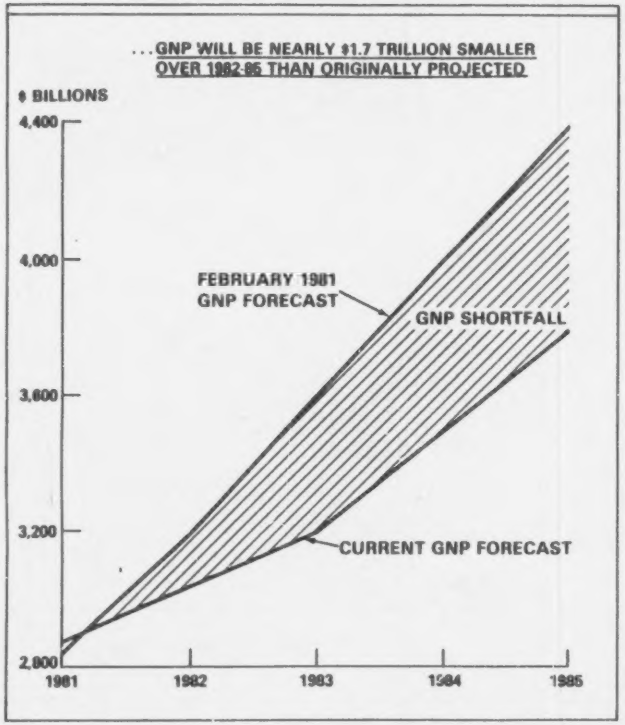


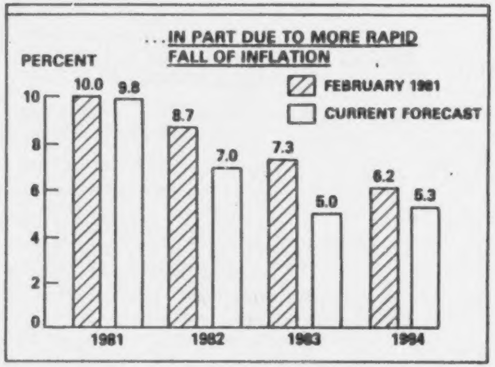
*SOCIAL SECURITY, MEDICARE, AND MEDICAID

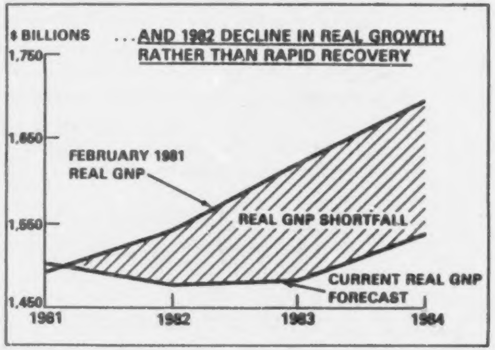
1970's Sources of the Structural Deficit

- Constant dollar cost of social contract programs quadrupled from 1963-1981 — rising from $50 to $220 billion (FY 1983$)
- Together with rapid growth in other entitlements, the overall entitlement claim on GNP rose by two-thirds — from 6% to 10% of GNP
- The overall non-defense claim expanded by 50% — from 12¢ to 18¢ on every dollar of GNP
- At the same time, a decade of neglect and underfunding caused severe deterioration of national defense capabilities — with budget resources at a low, unsustainable 5.5% of GNP
- The huge, structural imbalance in the inherited 1981 budget thus reflected:
  - Record overall spending at 23.6% of GNP that was driving up taxes and deficits
  - Defense spending that was far too low — imposing unfunded claims on future budgets
  - Automatic entitlement spending equaling 10¢ on every dollar of GNP — imposing high and rising claims on future budgets

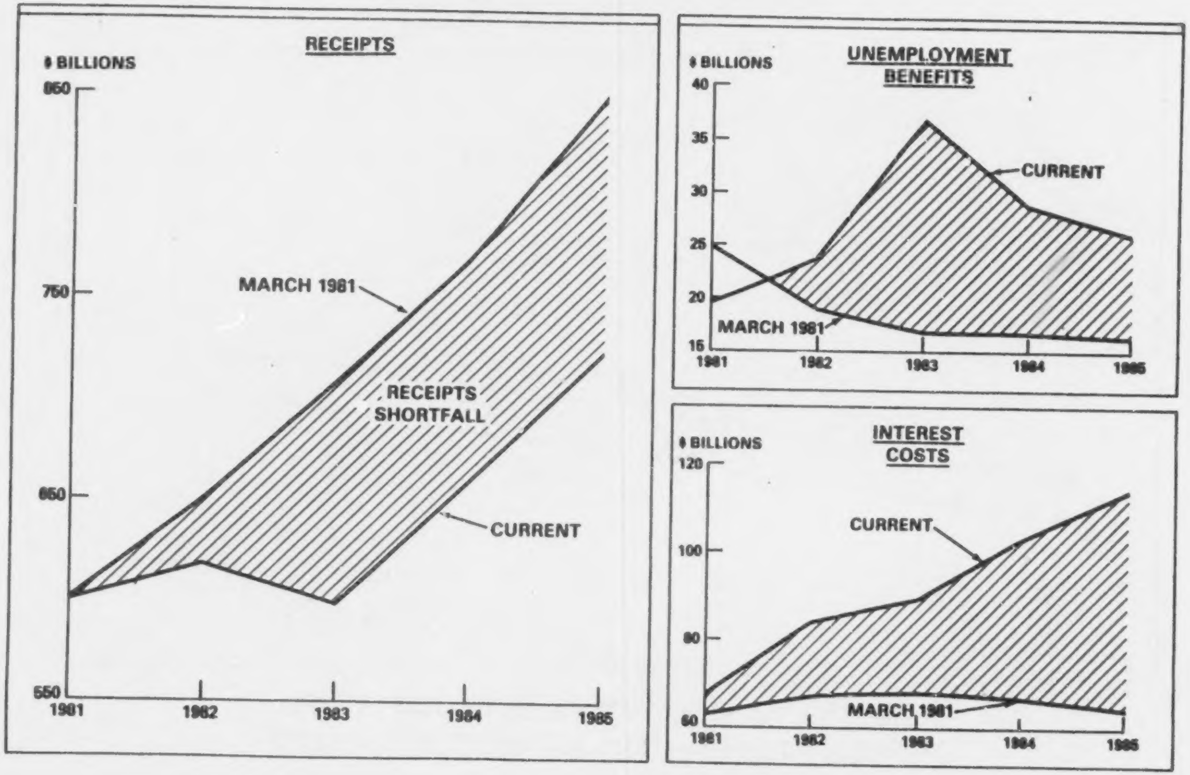
RAPID DISINFLATION AND DEEP RECESSION HAVE DRASTICALLY REDUCED GNP


...GNP WILL BE NEARLY $1.7 TRILLION SMALLER OVER 1982-85 THAN ORIGINALLY PROJECTED

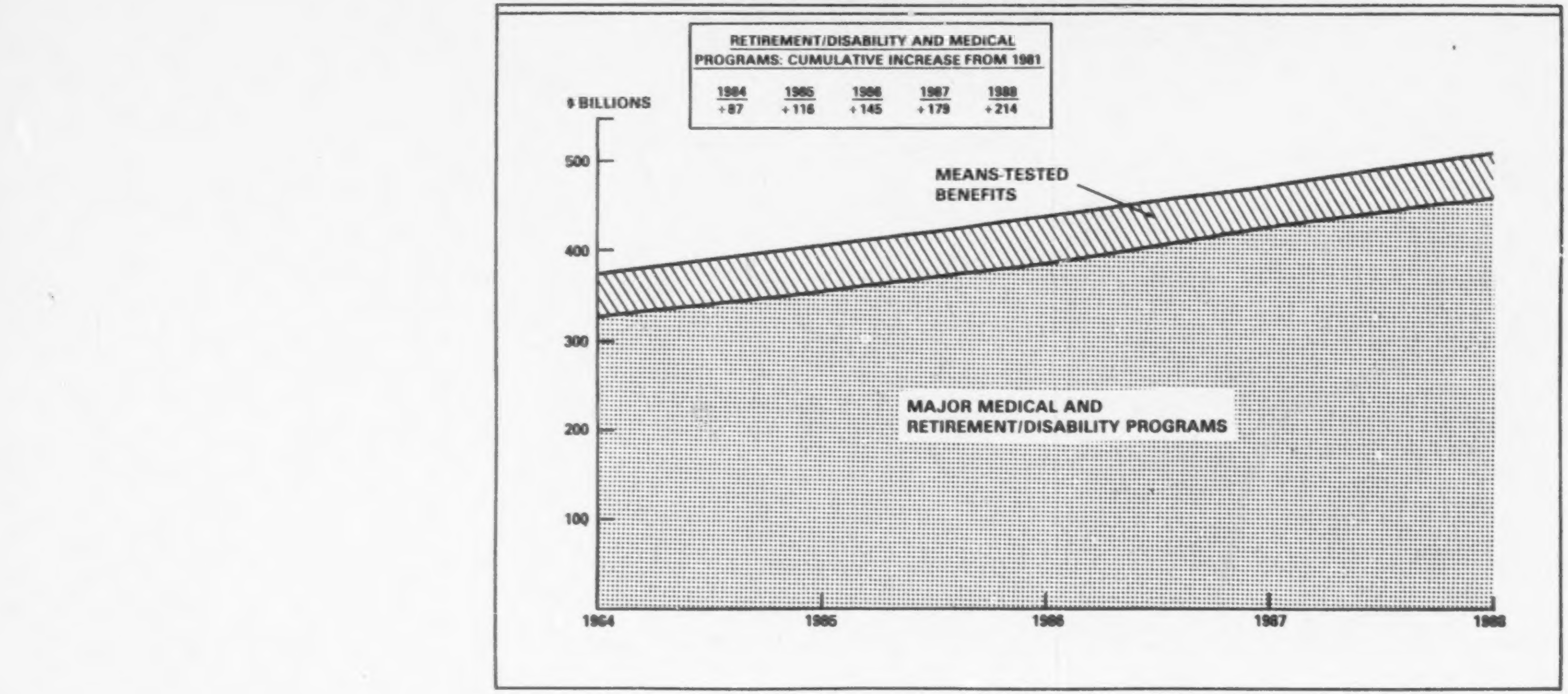

...IN PART DUE TO MORE RAPID FALL OF INFLATION


...AND 1982 DECLINE IN REAL GROWTH RATHER THAN RAPID RECOVERY

BUDGET IMPACT OF CHANGED ECONOMIC OUTLOOK

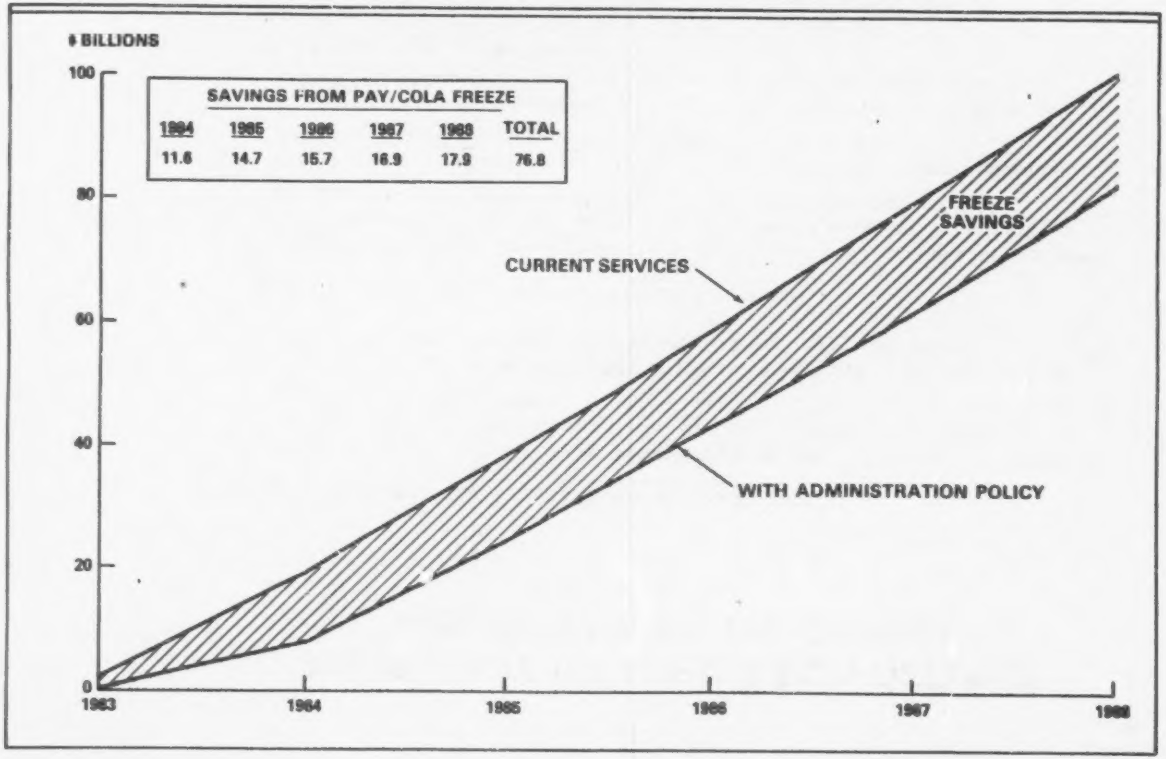


COMPOSITION OF CURRENT SERVICES BASELINE FOR TRANSFER PAYMENTS



PART III — MAJOR PROGRAM HIGHLIGHTS

BUDGET IMPACT OF FREEZE ON BASELINE COSTS OF INDEXED PROGRAMS AND PAY



SAVINGS FROM PAY/COLA FREEZE

1984	1985	1986	1987	1988	TOTAL
11.6	14.7	15.7	16.9	17.9	76.8

AGGREGATE FREEZE ON NON-DEFENSE DISCRETIONARY PROGRAMS

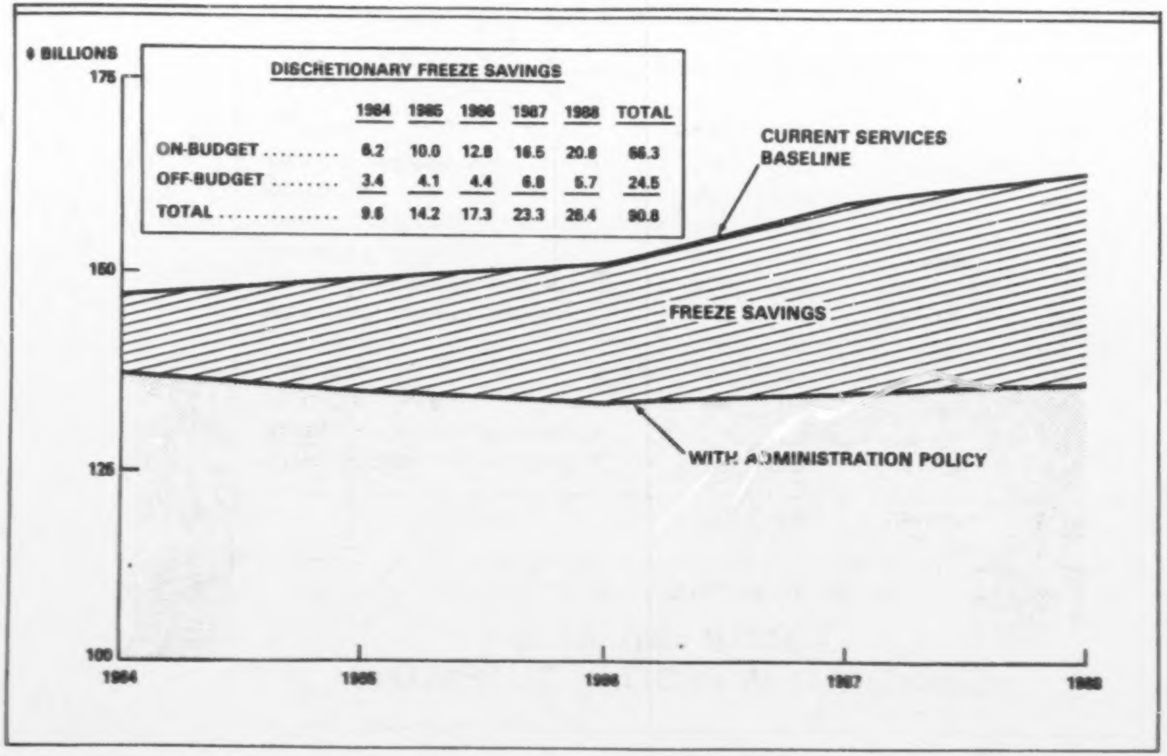
Level Request for Discretionary Programs

- 1984 request for annually funded discretionary programs is $112 billion compared to enacted 1983 appropriations of a similar level. Outlay savings of $4.8 billion compared to 1984 baseline.
- Various trust fund expenditure limits, obligation ceilings and off-budget spending and lending caps save nearly an additional $5 billion in FY 1984 outlays.

Application of Aggregate Freeze Concept

- Targeted high priority programs funded at levels above 1983 appropriation (e.g. law enforcement and anti-drug program, National Science Foundation, Head Start, displaced workers, veterans health care and transportation infrastructure).
- Most programs funded at actual 1983 appropriations (e.g. handicapped education, preventive health block grant, waste treatment grants and WIC).
- Some lower priority programs reduced to below 1983 appropriation to offset targeted increases (e.g. postal subsidies, energy R&D, EDA grants, mass transit, Amtrak and soil conservation).

BUDGET IMPACT OF DISCRETIONARY PROGRAM FREEZE



DISCRETIONARY FREEZE SAVINGS

	1984	1985	1986	1987	1988	TOTAL
ON-BUDGET	6.2	10.0	12.8	16.5	20.8	66.3
OFF-BUDGET	3.4	4.1	4.4	6.8	5.7	24.5
TOTAL	9.6	14.2	17.3	23.3	26.4	90.8

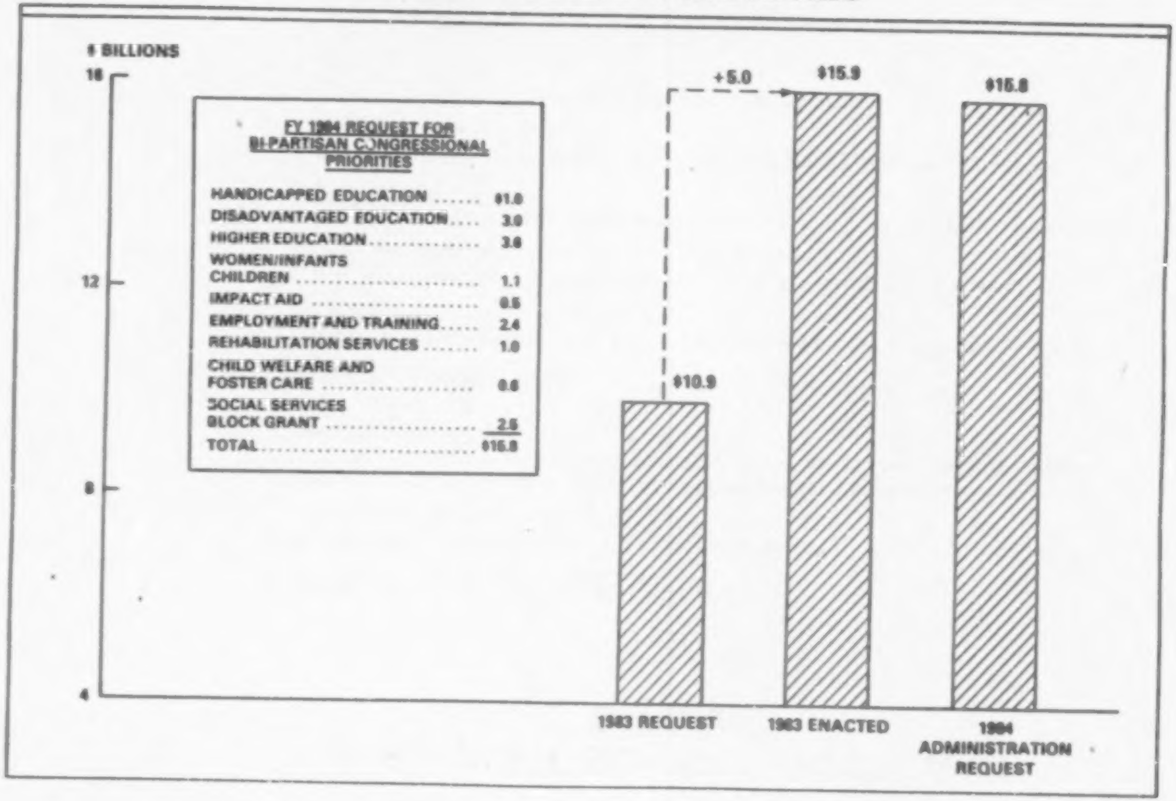
DOMESTIC PROGRAM INCREASES IN FY 1984 BUDGET

(BUDGET AUTHORITY, IN MILLIONS OF DOLLARS)

PROGRAM	1983	1984	INCREASE	
			AMOUNT	PERCENT
NATIONAL SCIENCE FOUNDATION	$1,099	$1,297	$ +198	+18%
SCIENCE AND MATH BLOCK GRANTS	0	50	+50	—
COLLEGE WORK-STUDY	540	850	+310	+57
HEAD START	912	1,051	+139	+15
FOSTER CARE	396	440	+45	+11
DISPLACED WORKERS PROGRAM	50	240	+190	+380
TRAINING AND EMPLOYMENT SERVICES	3,704	4,281	+577	+16
VA MEDICAL CARE	8,292	8,900	+608	+11
LAW ENFORCEMENT	3,045	3,348	+303	+10
HIGHWAYS*	8,100	12,600	+4,500	+56
AIRPORTS AND AIRWAYS	4,180	5,031	+851	+20
TOTAL	$30,317	$38,088	$ +7,771	+26%

*OBLIGATION LIMITATION PRIOR TO PASSAGE OF GAS TAX LEGISLATION

1984 BUDGET: RECOGNITION OF KEY CONGRESSIONAL PRIORITIES



FY 1984 REQUEST FOR BI-PARTISAN CONGRESSIONAL PRIORITIES

HANDICAPPED EDUCATION	$1.0
DISADVANTAGED EDUCATION	3.0
HIGHER EDUCATION	3.6
WOMEN/INFANTS CHILDREN	1.1
IMPACT AID	0.5
EMPLOYMENT AND TRAINING	2.4
REHABILITATION SERVICES	1.0
CHILD WELFARE AND FOSTER CARE	0.8
SOCIAL SERVICES BLOCK GRANT	2.5
TOTAL	$15.8

FARM PRICE SUPPORT FREEZE AND REFORM

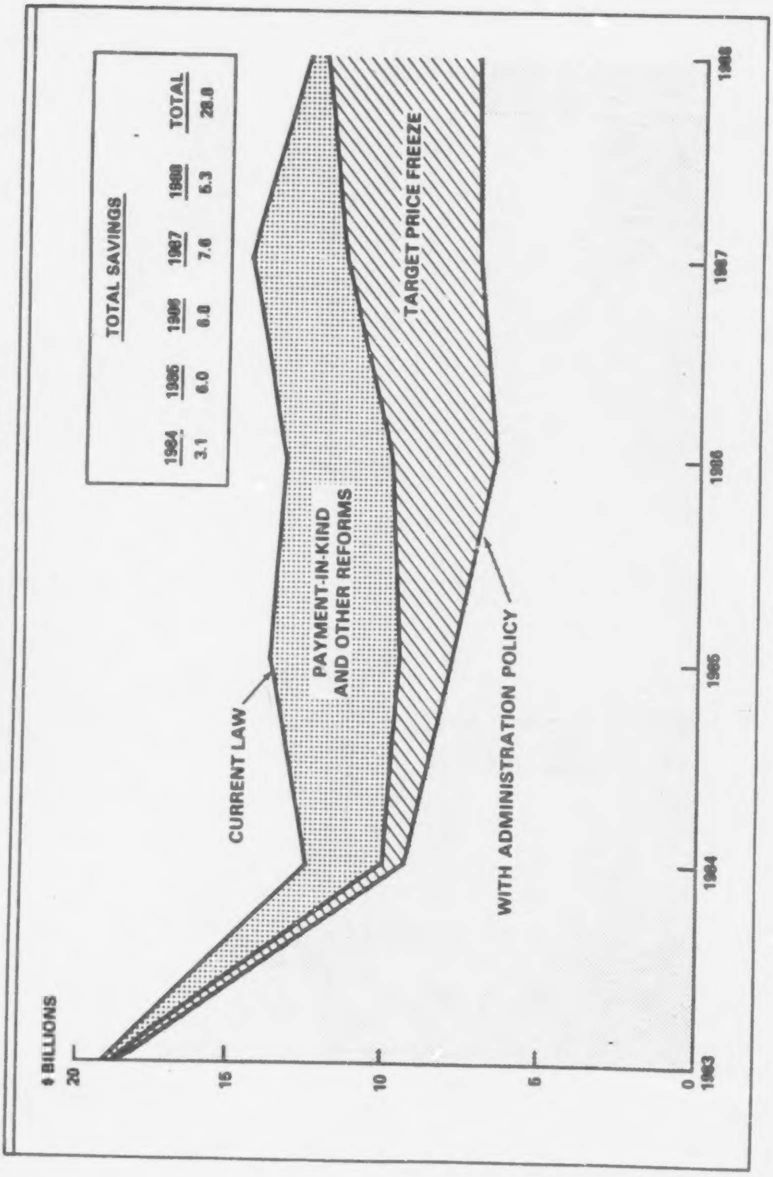
Runaway Costs if We Do Nothing

- Historic record of $19 billion in CCC outlays in 1983 and $86 billion over 1983-88 if current programs are not changed.
- Farm program cost averaged $4.2 billion (constant dollars) per year between 1932-1981. Average would triple — to $12 billion per year — over 1982-88 without Administration reforms.

Freeze and Reform Plan

- A payment in kind program (PIK) to cut both farm production and surplus stocks at the same time. (Crop loans forgiven in return for acreage set-aside.)
- A freeze on wheat, corn and other "target" prices in keeping with the drop in inflation and production costs and to discourage over-production.
- An aggressive export policy using commercial and Government channels to increase U.S. farm trade.
- $1/hundred weight assessment to encourage lower dairy production and reduce massive government stocks.
- Saves $3.1 billion in FY 1984 and $29 billion over five years.

FARM PRICE SUPPORTS

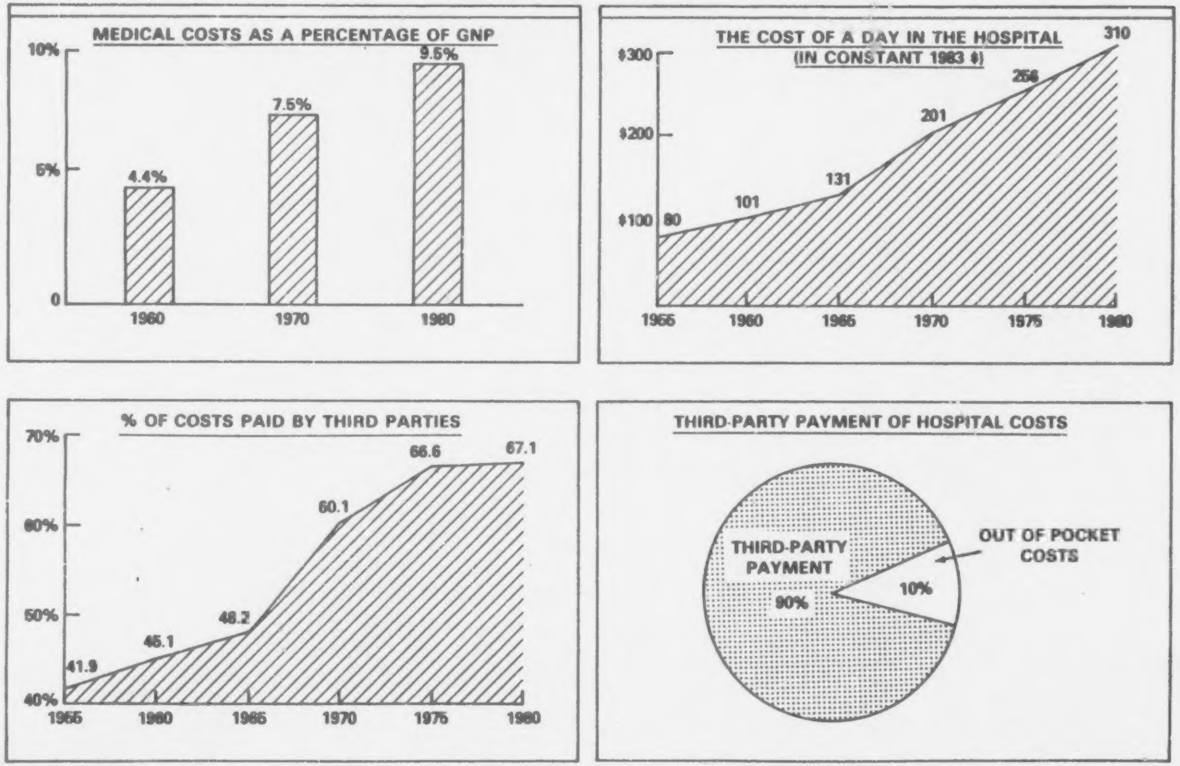


TOTAL SAVINGS

1984	1985	1986	1987	1988	TOTAL
3.1	6.0	6.8	7.6	5.3	28.8

20

THE NEED TO CONTROL EXPLODING MEDICAL CARE COSTS



HEALTH CARE REFORM PACKAGE

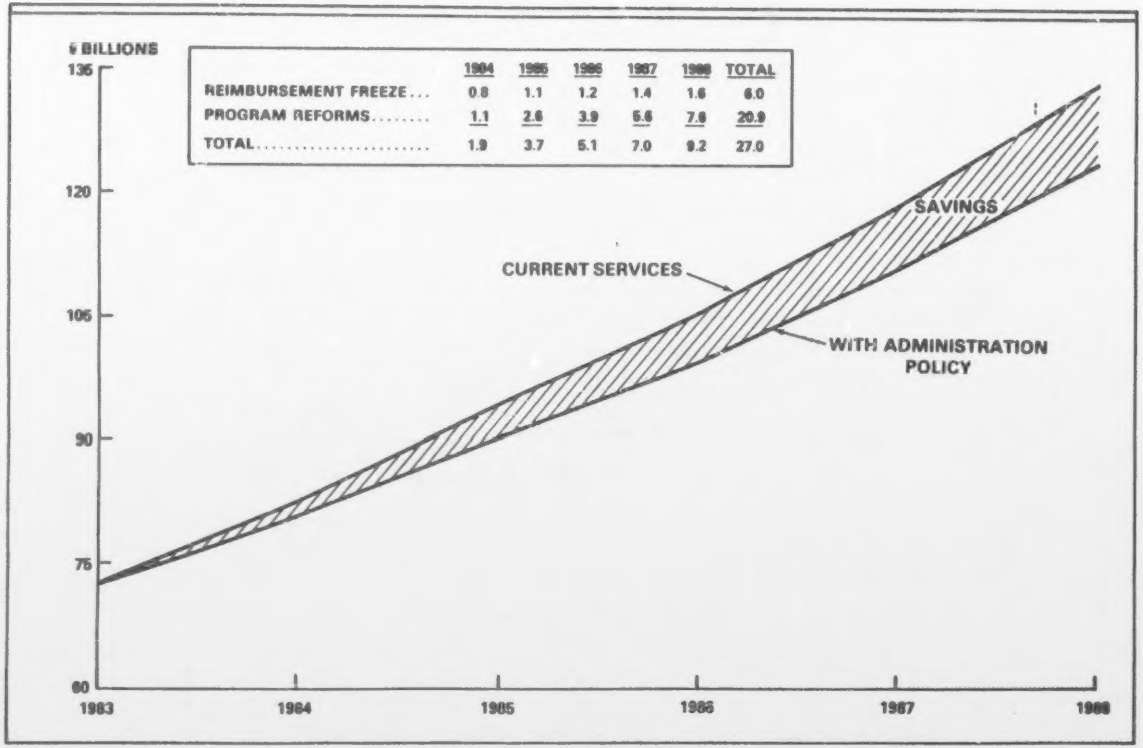
Uncontrolled Costs and Spending

- Inflationary health care system has driven up Medicare/Medicaid outlays from $22 billion in 1975 to $75 billion in 1983. 1984-88 baseline spending would exceed one-half trillion dollars without reforms.

Health Care Reform Package

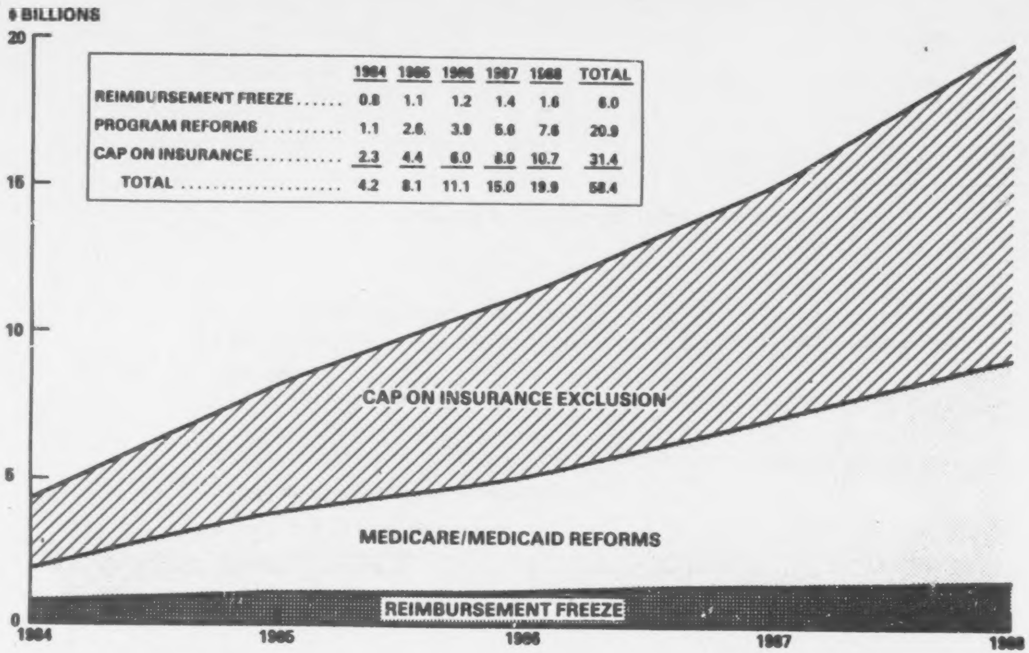
- 1984 freeze on physician payments and hospital reimbursement ceiling saves $6 billion over 5 years.
- Permanent hospital reimbursement reform with fixed payment per case system (DRG). (Five-year savings of $20 billion assumed in current law baseline.)
- Hospital co-payments of 8% ($28/day) through 15th day and 5% ($17.50/day) through 60th day coupled with catastrophic protection thereafter (reduces patient cost of 6-month extended illness from $19,075 to $1,530).
- Phased increase in SMI physician insurance premium to 35% of program cost by 1988 compared to 25% at present and original law provision for 50%.
- Extension of state Medicaid cost control ceilings and mandatory co-payments to reduce over-utilization ($1.00/day for hospital and $1.00/visit for physician services).
- $175/month cap on tax free exclusion of employer health benefit plans to curtail excessive first dollar coverage and encourage consumer cost consciousness.

MEDICAL ENTITLEMENT REFORMS



	1984	1985	1986	1987	1988	TOTAL
REIMBURSEMENT FREEZE . . .	0.8	1.1	1.2	1.4	1.6	6.0
PROGRAM REFORMS	1.1	2.6	3.9	5.6	7.8	20.9
TOTAL	1.9	3.7	5.1	7.0	9.2	27.0

HEALTH CARE REFORM PLAN
BUDGET SAVINGS



	1984	1985	1986	1987	1988	TOTAL
REIMBURSEMENT FREEZE	0.8	1.1	1.2	1.4	1.6	6.0
PROGRAM REFORMS	1.1	2.6	3.9	5.6	7.6	20.9
CAP ON INSURANCE	2.3	4.4	6.0	8.0	10.7	31.4
TOTAL	4.2	8.1	11.1	15.0	19.9	58.4

BIPARTISAN SOLUTION TO SOCIAL SECURITY SOLVENCY

Five Major Features Impact Unified Budget Deficit

- 6-month COLA freeze.
- 1984 and 1988 payroll tax rescheduling.
- Inclusion of 50% of benefits in income tax base for those above $20/25,000 — to recapture part of unearned benefit.
- Coverage extension to new Federal and non-profit employees; ban on state and local withdrawal.
- Self-employment tax increase to 100% of combined employee/employer rate — with deductibility for employer share.

Budget Savings Due to Bipartisan Solution

Provision	1984	1985	1986	1987	1988	Total
1) COLA freeze	4.2	4.6	4.9	5.4	5.7	24.8
2) Payroll tax rescheduling	5.5	+2.1	0.0	0.0	9.4	13.0
3) Benefit taxation	1.1	4.0	4.7	5.5	6.4	21.7
4) Coverage provisions	1.1	2.0	2.8	3.6	4.6	14.1
5) Self-employment tax	0.6	1.6	1.5	1.6	1.9	7.1
6) SSI and other	+0.2	+0.2	+0.2	+0.3	+0.3	+1.2
7) Total	12.2	10.0	13.6	15.8	27.7	79.4

CIVIL SERVICE RETIREMENT SYSTEM REFORM

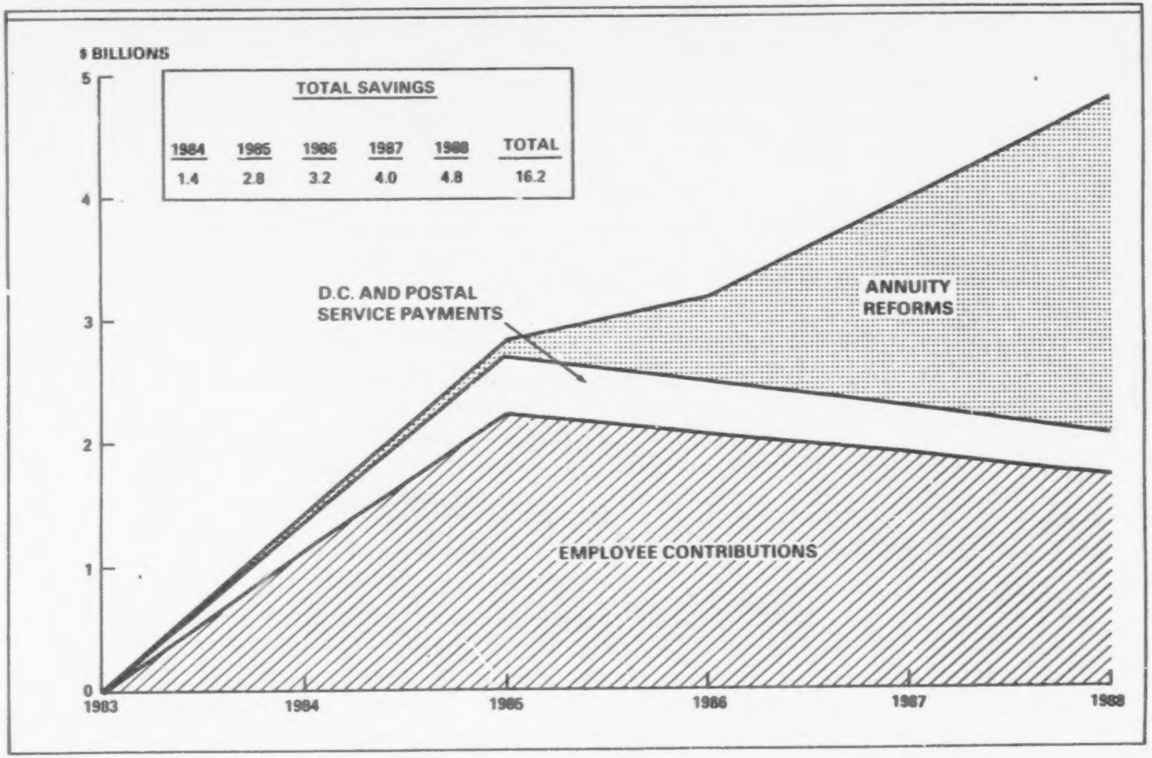
Current System Not Affordable or Viable

- $499 billion unfunded liability.
- System cost equals 37% of Federal payroll — most costly/generous system known.
- GS-14 who retired ten years ago at age 55 now receives $34,140/year annuity plus Federal health benefits.
- Retirement outlays up from $2.8 billion in 1970 to $21.1 billion in 1983 — with 1984-88 baseline costs of $121 billion absent reform.

Proposed Civil Service Retirement Reform Plan

- Reduces long-run system costs to 22% of payroll through:
    - Shift to High-Five;
    - 10-year phase-in of 5%/year annuity reduction for retirement between 55 and 65;
    - Modification of annuity replacement formula, if necessary.
- Employee contribution raised from 7% to 11% (half of reformed system cost) in two steps over 1984-85.
- Postal Service and D.C. required to fund fair share of costs for employees who participate in Civil Service Retirement system.
- Reform plan saves $1.4 billion in 1984 and $16.2 billion over 5 years.

BUDGET SAVINGS FROM STRUCTURAL REFORMS OF FEDERAL RETIREMENT PROGRAMS



TOTAL SAVINGS

1984	1985	1986	1987	1988	TOTAL
1.4	2.8	3.2	4.0	4.8	16.2

MEANS-TESTED ENTITLEMENT REFORM

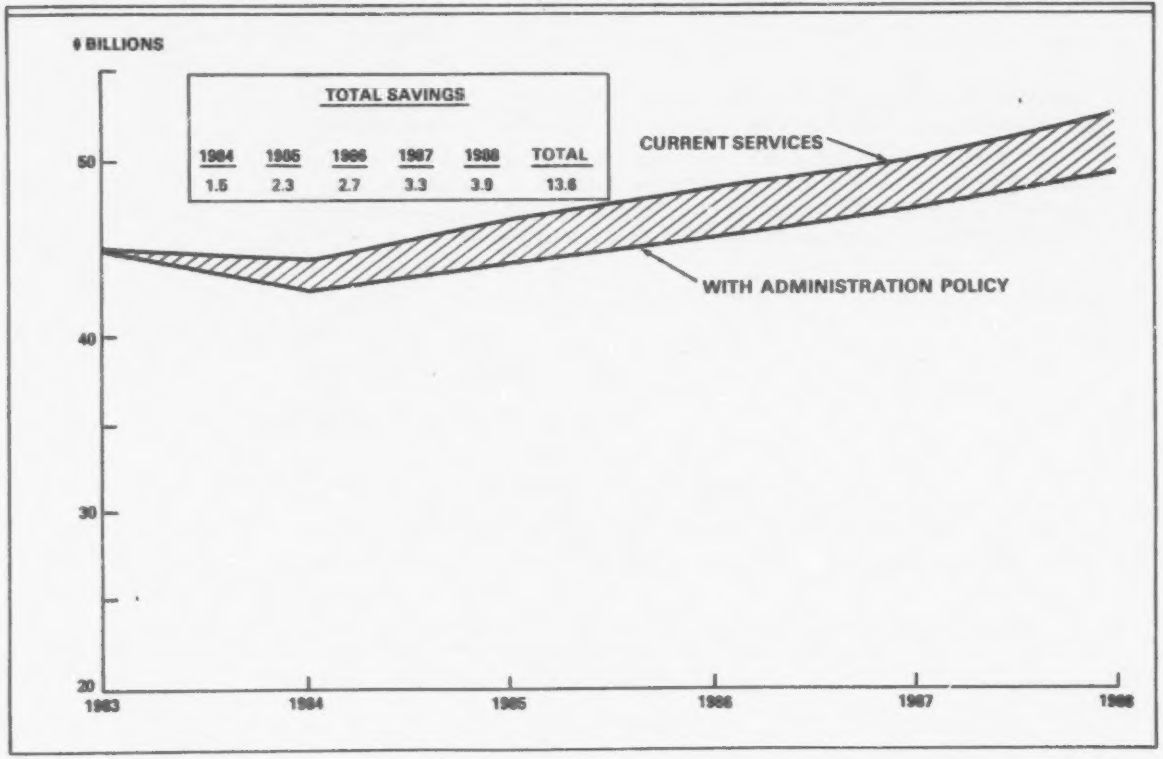
Baseline Costs and Proposed Savings

- Enacted Administration reforms have curtailed explosive welfare spending growth of 1970's — but baseline costs are still $243 billion over 1984-88 without further reforms.
- Proposed reforms save nearly $14 billion over 5 years — or 5.6% of baseline costs. Major focus is on error rate reduction, mandatory workfare and simplification of eligibility and benefit determination — so benefits to truly needy fully protected. Proposed spending level for these programs still highest in history.

Significant Program Changes

- Food Stamps — mandatory workfare, simplification of benefit calculation by standardizing current shelter and earnings deductions, and reduction of allowable state error rate to 3%.
- Child Nutrition — block grant at 85% of current level for summer feeding, child care and school breakfast program.
- AFDC — mandatory workfare, include all household members in assistance unit, prorate shelter and utility costs if shared household, end parents' benefit when child reaches 16 (conform to Social Security), restructure child support enforcement program incentives, and mandate collection of medical support from absent parents.
- Subsidized Housing Program — count Food Stamps as income, continue lower cost voucher approach and cap net additional subsidized units at average of 85,000 per year.

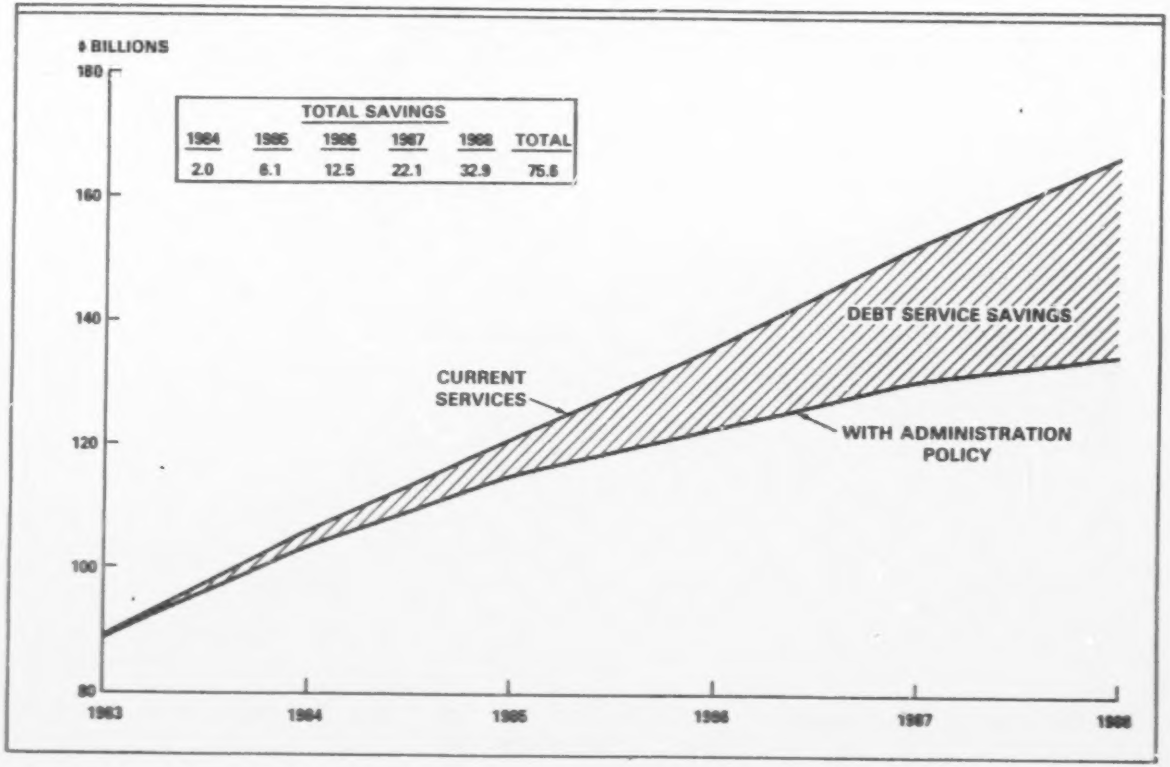
MEANS-TESTED ENTITLEMENTS



TOTAL SAVINGS

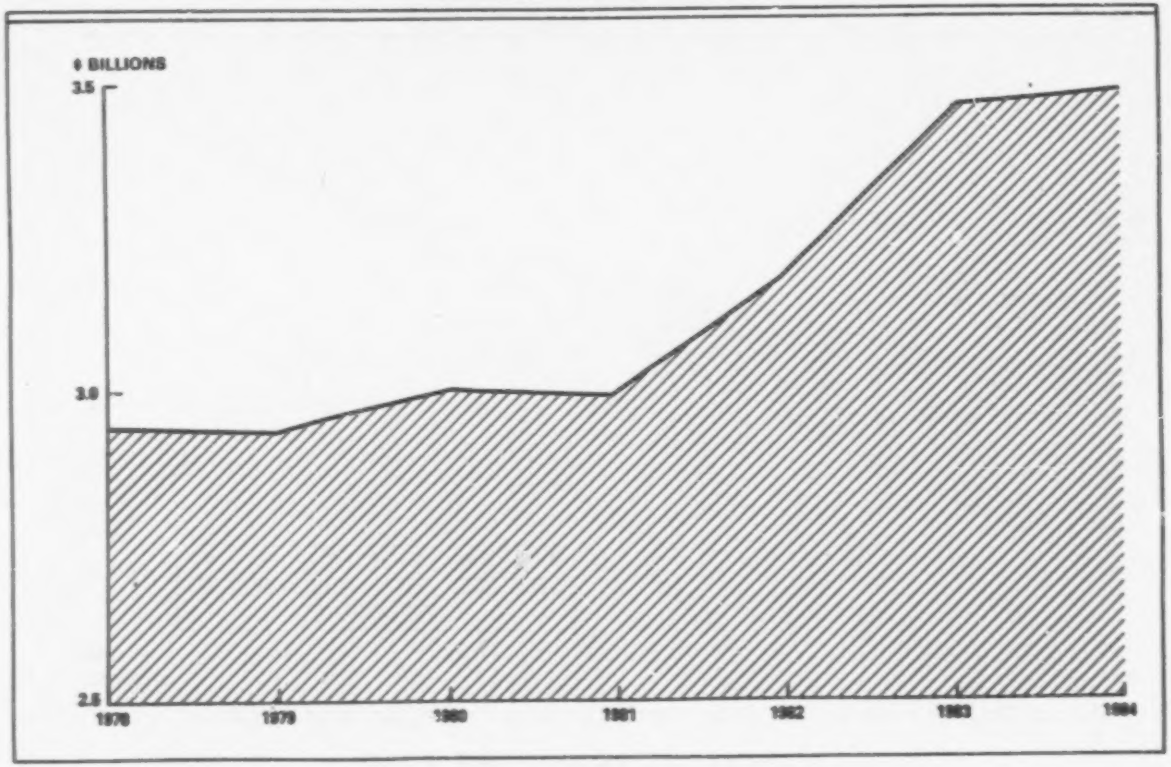
1984	1985	1986	1987	1988	TOTAL
1.5	2.3	2.7	3.3	3.9	13.6

NET INTEREST OUTLAYS

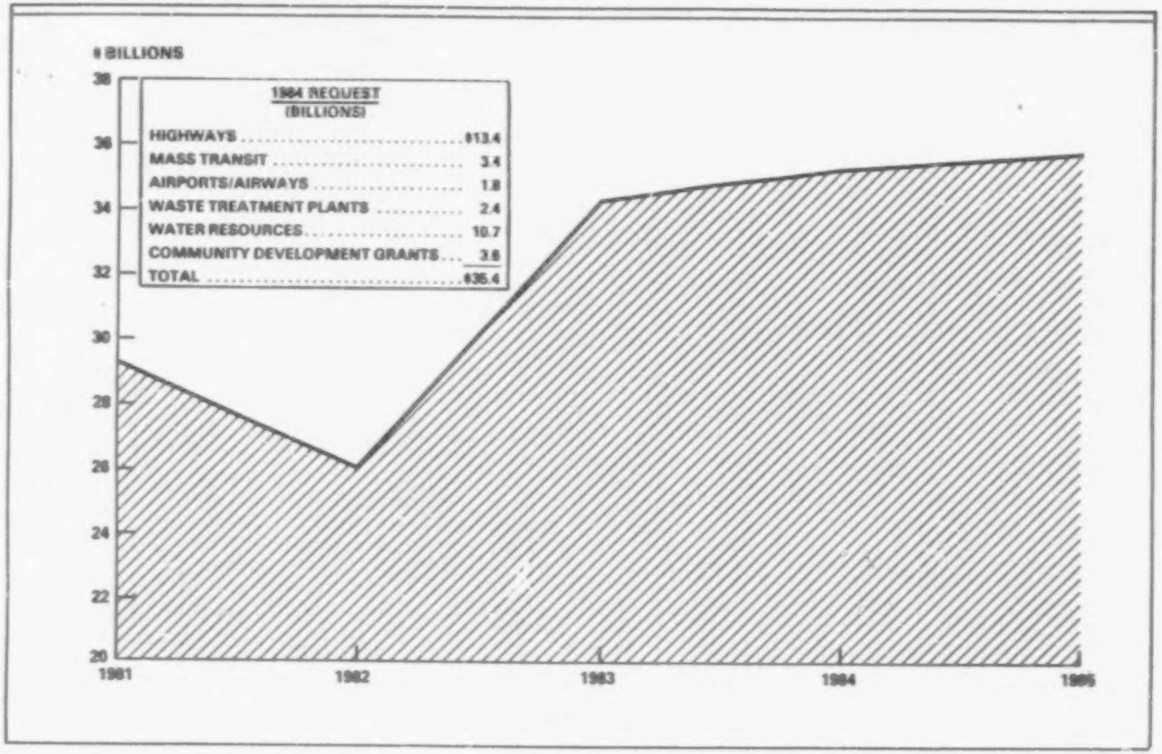


MORE ADEQUATE FUNDING FOR LAW ENFORCEMENT

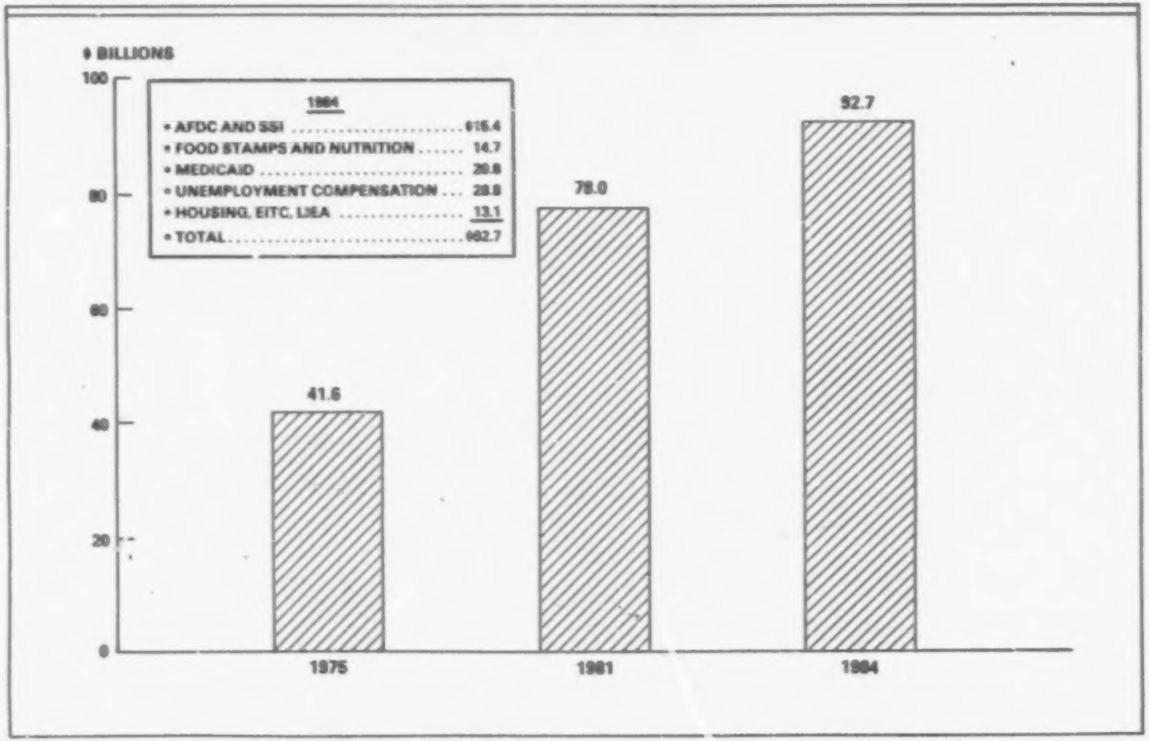
(CONSTANT FY 1983 DOLLARS)



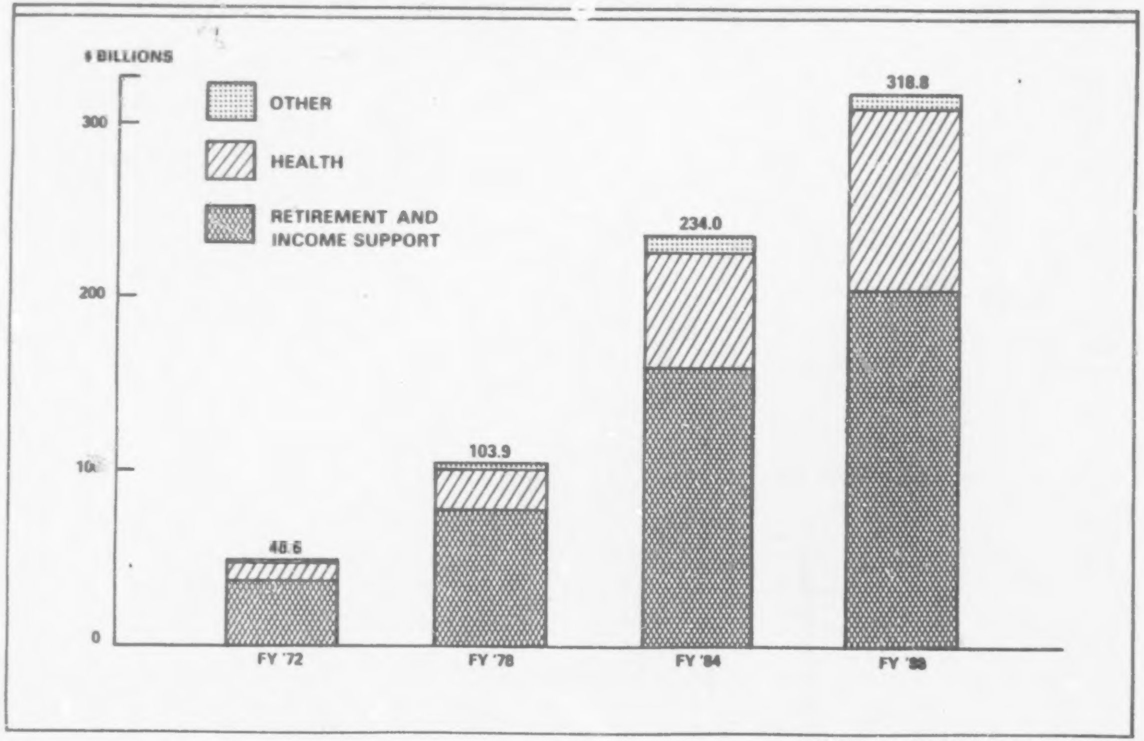
FUNDING FOR PUBLIC INFRASTRUCTURE



MAINTENANCE OF THE SOCIAL SAFETY NET— FEDERAL OUTLAYS FOR UNEMPLOYED AND LOW-INCOME



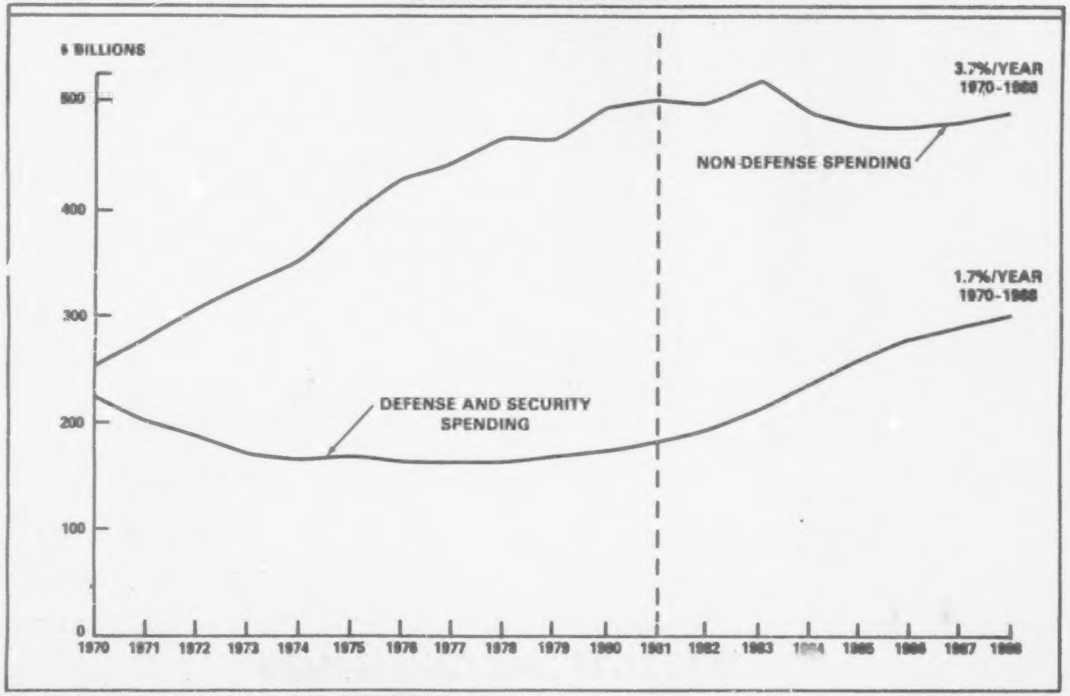
FEDERAL OUTLAYS BENEFITING THE ELDERLY



PART IV — DEFENSE BUDGET

BUDGET PRIORITIES SHIFT IN HISTORICAL PERSPECTIVE

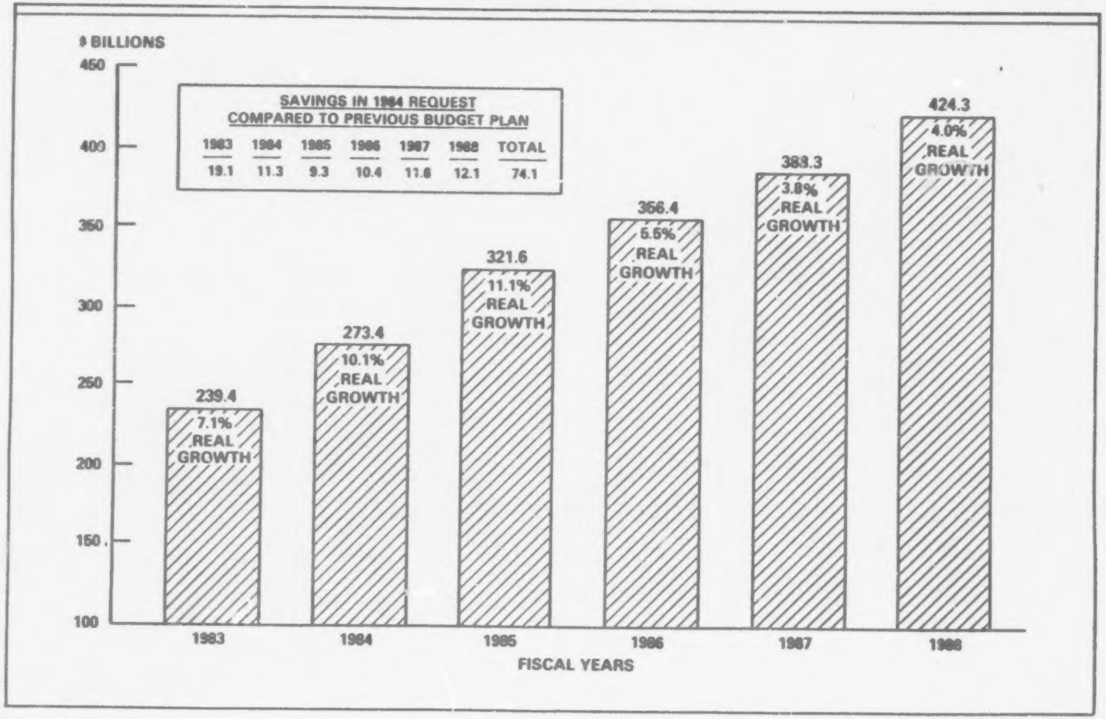
(CONSTANT FY 1983 DOLLARS)



MILITARY RETIRED PAY INCLUDED IN NON-DEFENSE SPENDING
NONDEFENSE SPENDING EXCLUDES NET INTEREST

DEPARTMENT OF DEFENSE BUDGET
1983–1988

(BUDGET AUTHORITY)

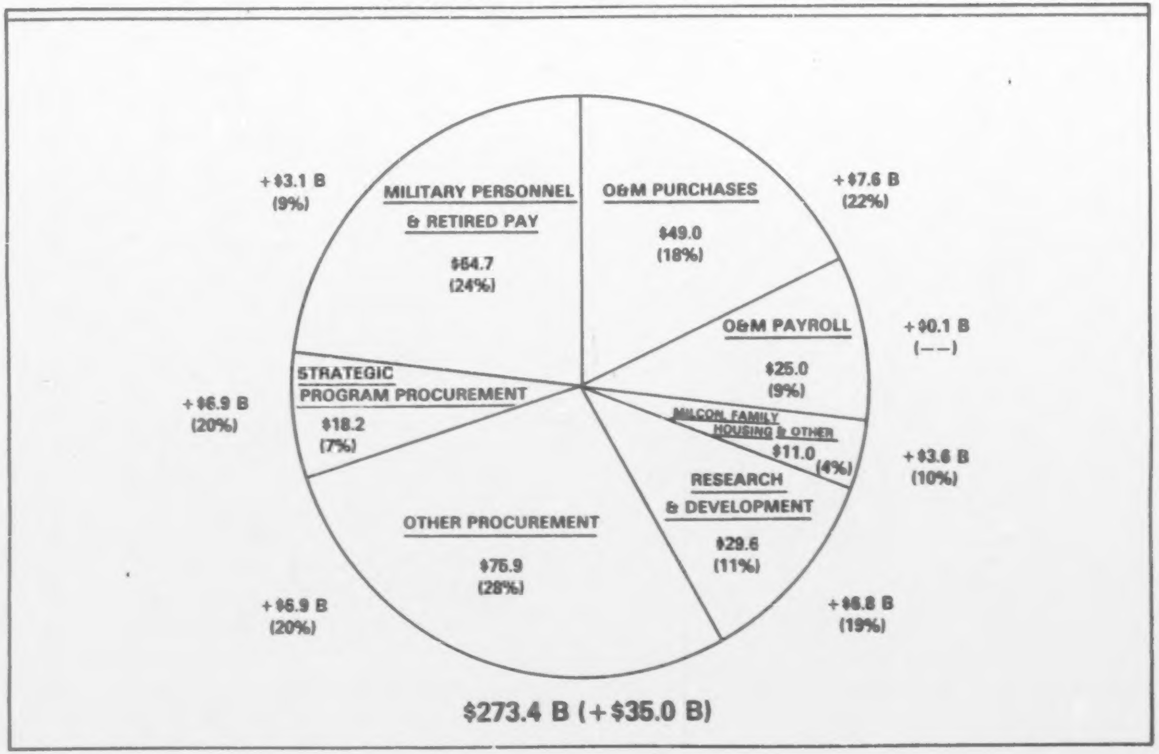


SAVINGS IN 1984 REQUEST COMPARED TO PREVIOUS BUDGET PLAN

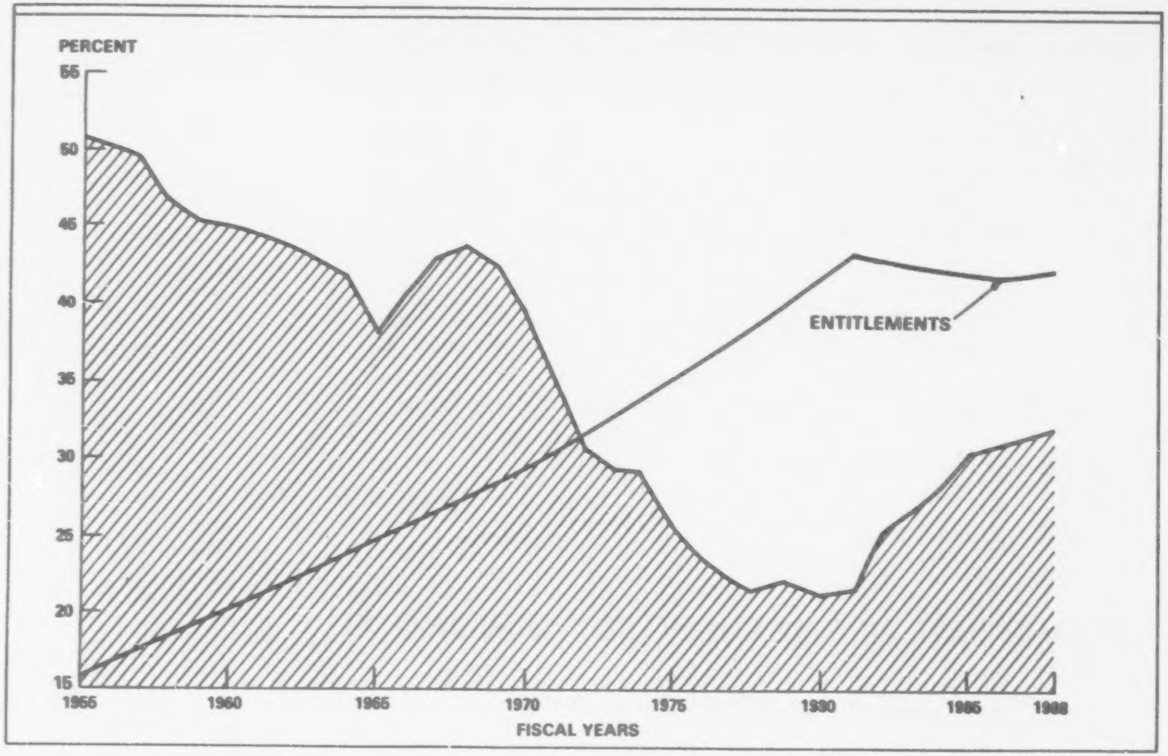
1983	1984	1985	1986	1987	1988	TOTAL
19.1	11.3	9.3	10.4	11.6	12.1	74.1

COMPOSITION OF 1984 DOD BUDGET

(BUDGET AUTHORITY; IN BILLIONS $)



DEFENSE SHARE OF BUDGET



PART V - ECONOMIC ASSUMPTIONS

ECONOMIC ASSUMPTIONS IN 1984 BUDGET

Real GNP

- Recovery begins this quarter and builds steadily until mid-year — averaging 4% real growth thereafter through 1988.
- Moderate recovery reflects steady rebuilding of inflation-damaged economy and avoids boom/bust pattern that could rekindle inflation later.
- 6-year real growth projection equals historic average for post-World War II recoveries, while inflation averages 43% lower than 1978-80.

Unemployment

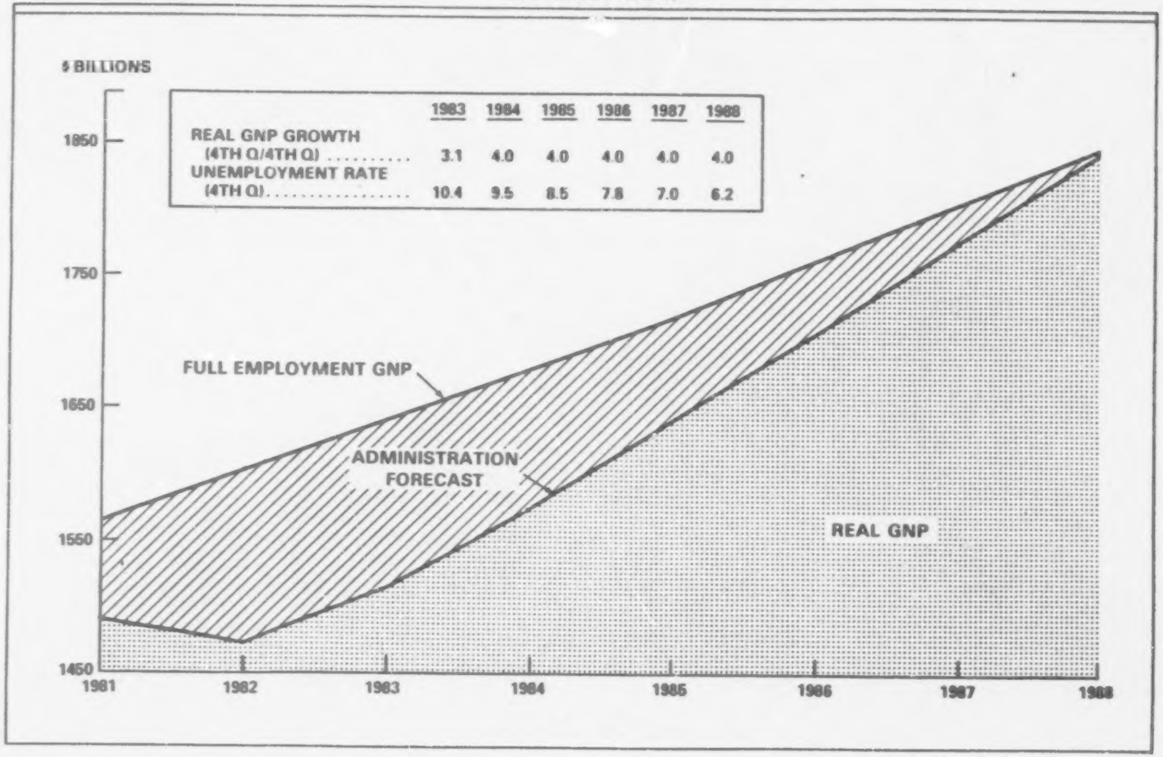
- Unemployment peaks in 1983 first half and steadily declines thereafter — with 1.6 million more jobs by fall 1983 and 4.6 million more by fall 1984.
- In out-years, unemployment rate declines three-fourths of a percent per year — reaching 6.2% by end of 1988 — representing 15 million more jobs than at present.

Inflation and Interest Rates

- Interest rates and inflation continue moderate decline over next several years with T-bill at 5.9% by 1988 and CPI at 4.4%.

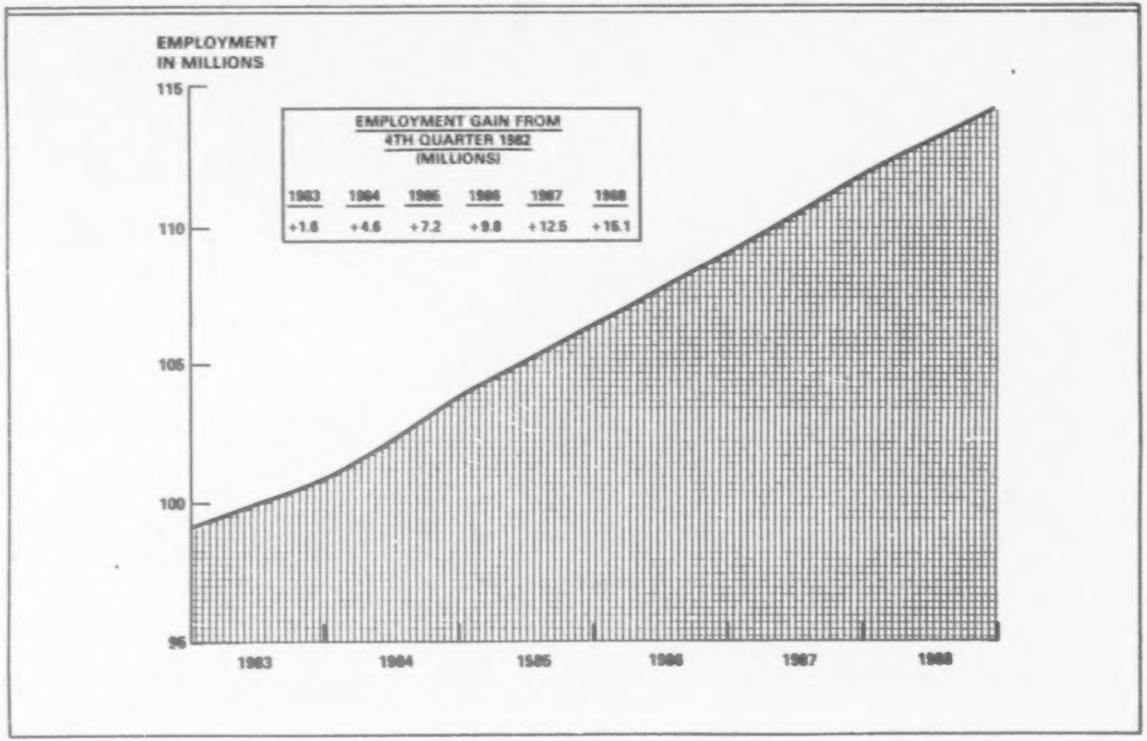
REAL GNP FORECAST VS FULL EMPLOYMENT GNP

(CONSTANT 1972 $)

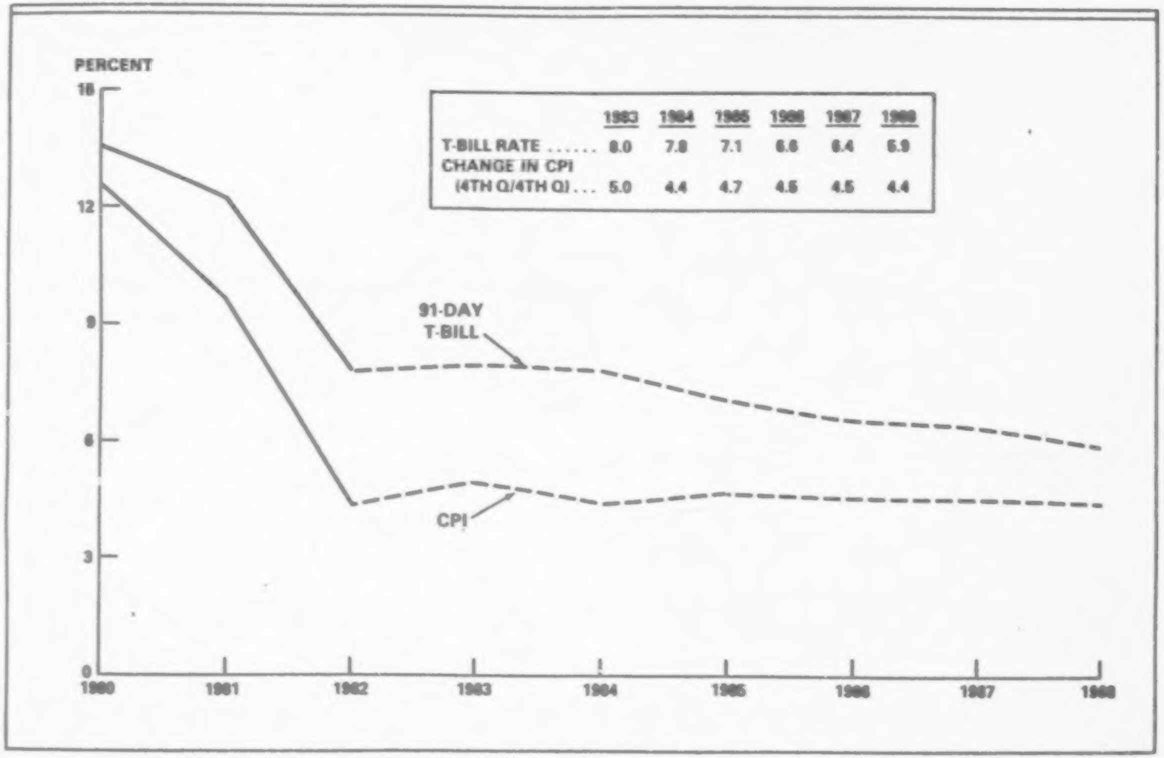


	1983	1984	1985	1986	1987	1988
REAL GNP GROWTH (4TH Q/4TH Q)	3.1	4.0	4.0	4.0	4.0	4.0
UNEMPLOYMENT RATE (4TH Q)	10.4	9.5	8.5	7.8	7.0	6.2

ECONOMIC RECOVERY: 15 MILLION NEW JOBS

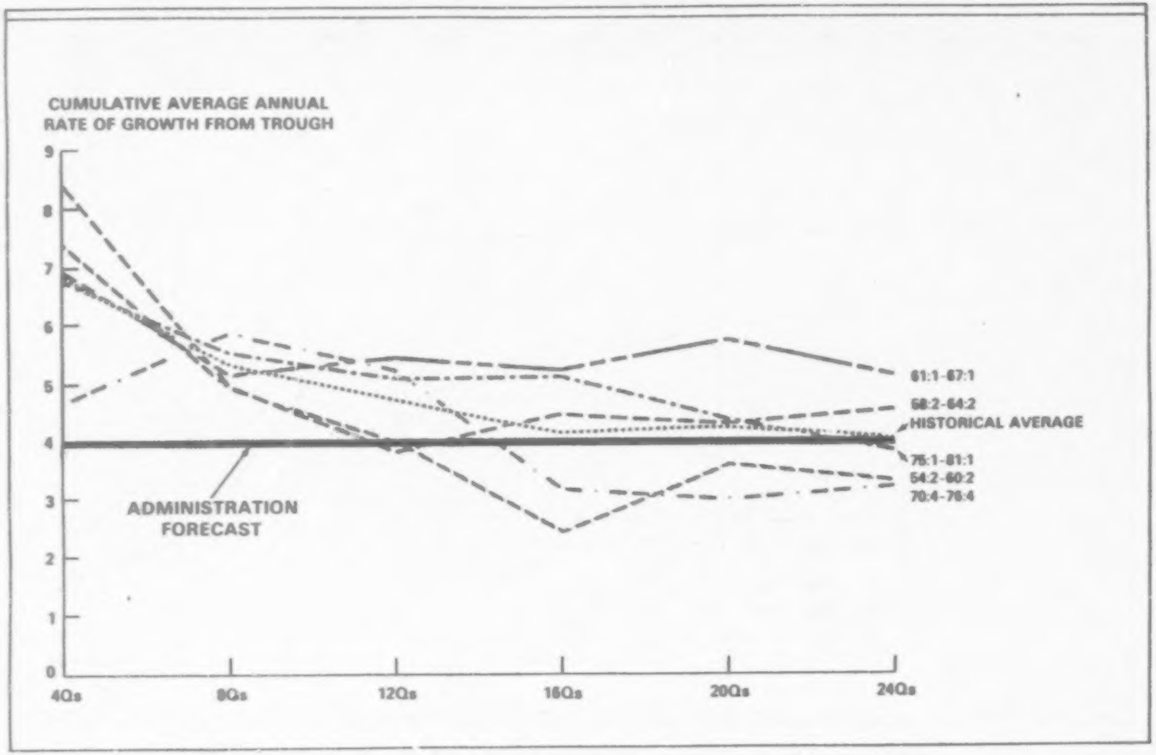


INFLATION AND INTEREST RATE TRENDS

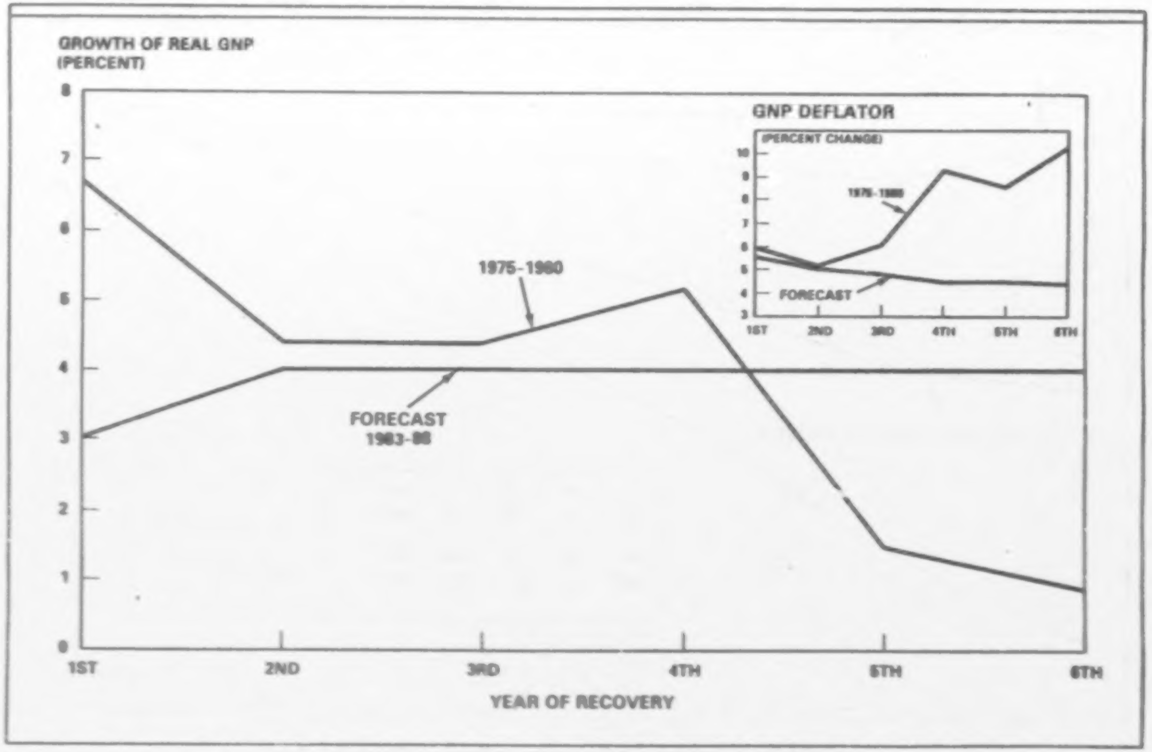


	1983	1984	1985	1986	1987	1988
T-BILL RATE	8.0	7.8	7.1	6.6	6.4	5.9
CHANGE IN CPI (4TH Q/4TH Q) . . .	5.0	4.4	4.7	4.6	4.5	4.4

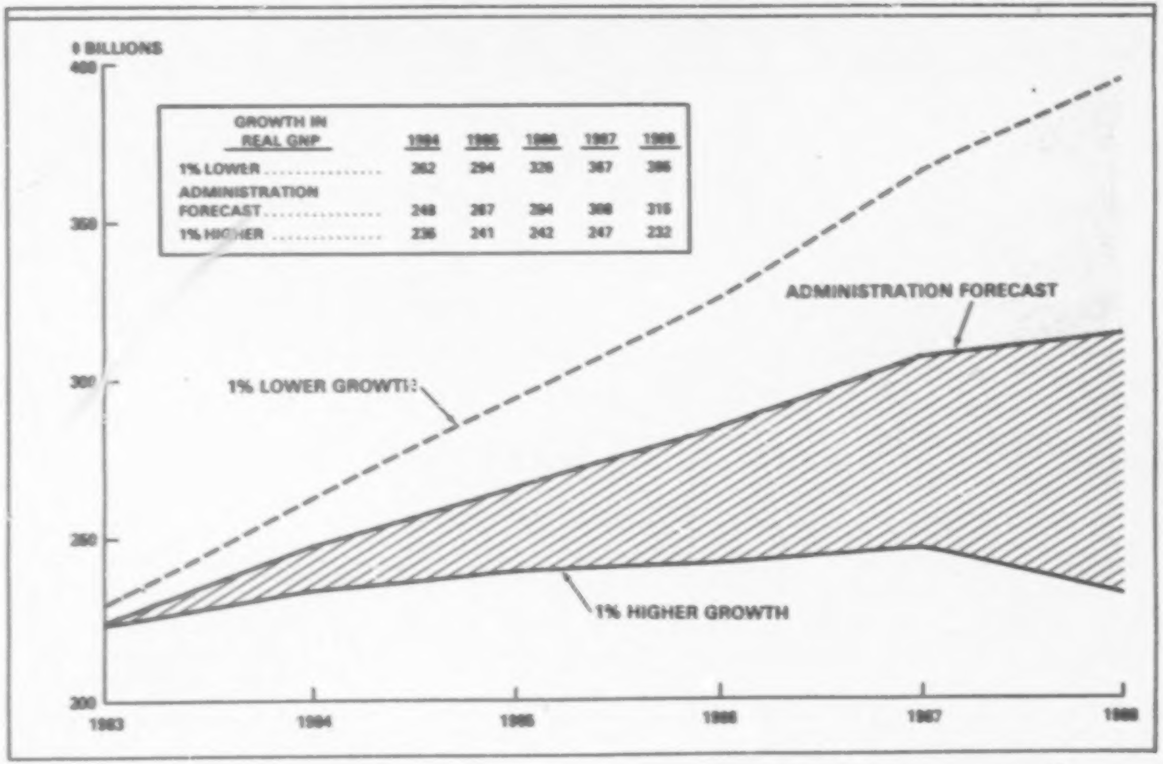
SIX-YEAR REAL GNP GROWTH FORECAST COMPARED TO HISTORICAL RECOVERY CYCLE EXPERIENCE



ADMINISTRATION FORECAST VS 1975 RECOVERY

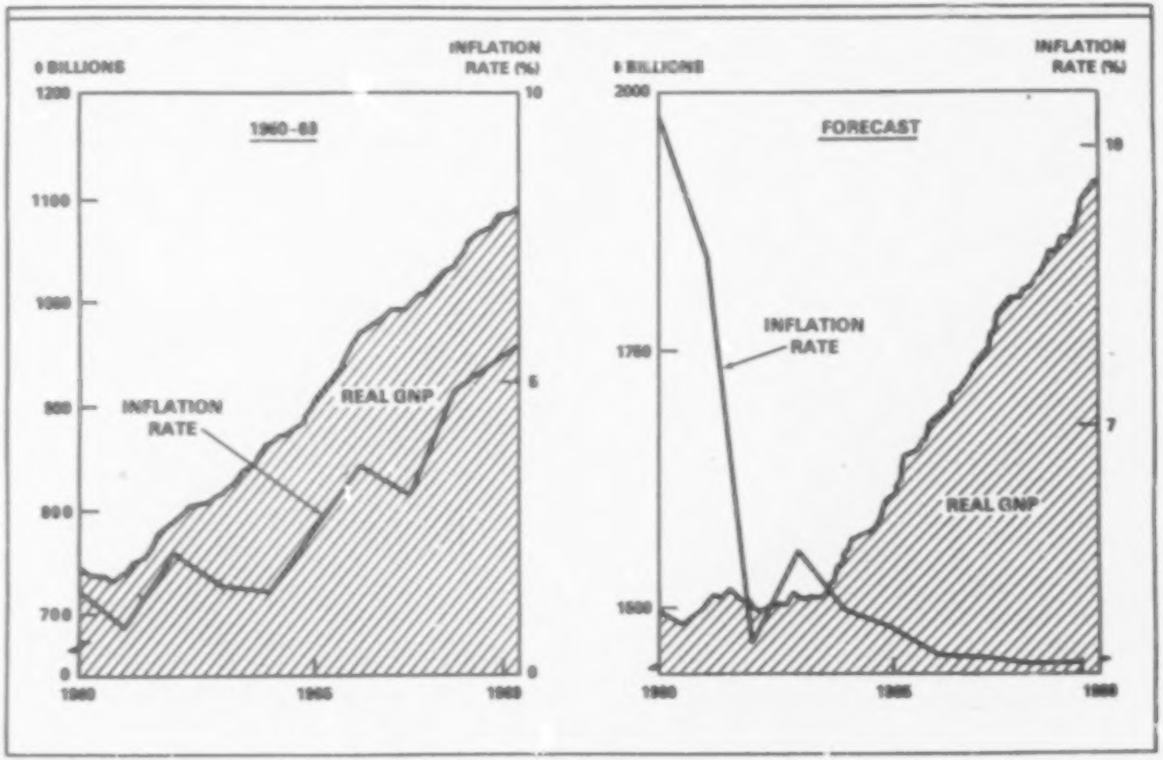


CURRENT SERVICES DEFICITS WITH ALTERNATIVE GROWTH PATHS



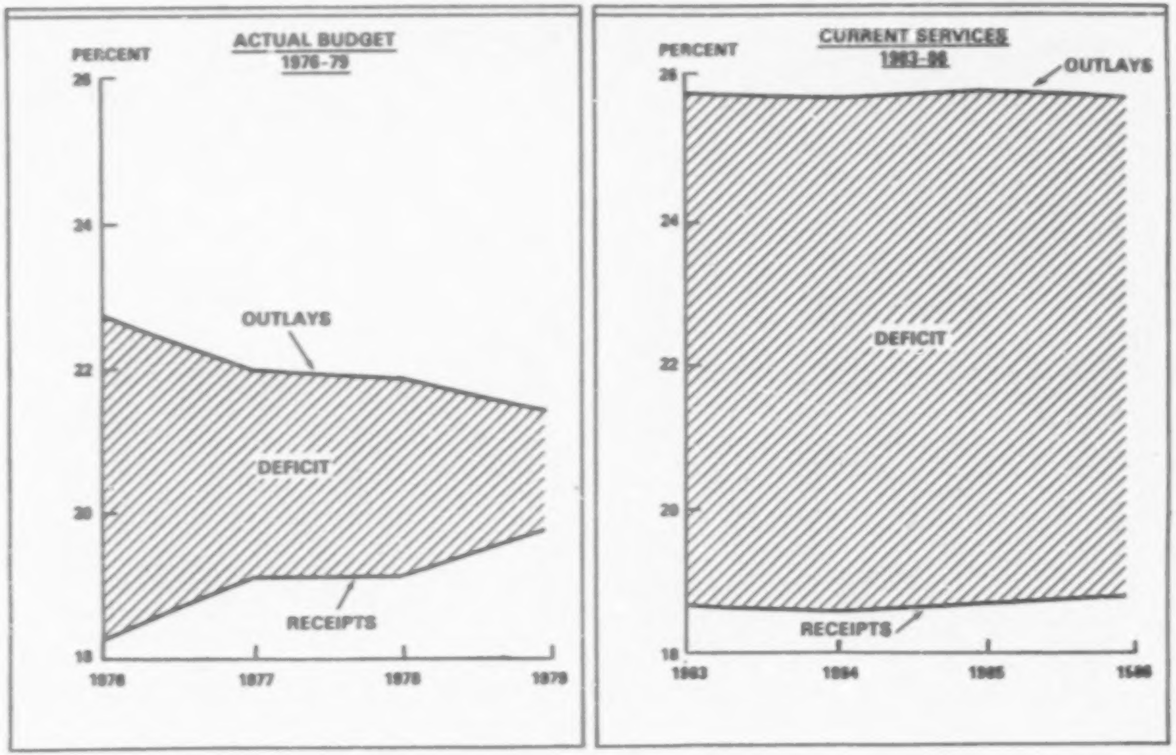
GROWTH IN REAL GNP	1984	1985	1986	1987	1988
1% LOWER	262	294	326	367	386
ADMINISTRATION FORECAST	248	267	294	308	316
1% HIGHER	236	241	242	247	232

ADMINISTRATION FORECAST VS 1960'S



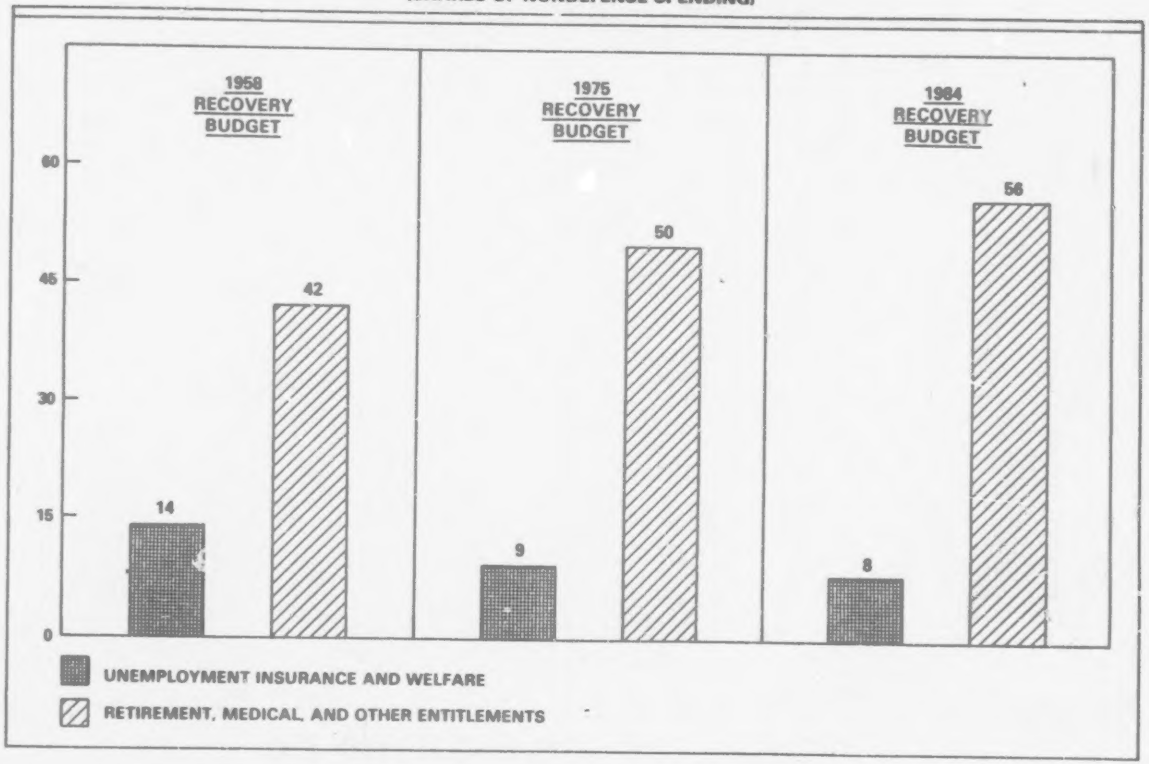
CHANGE IN BUDGET RESPONSE TO RECOVERY
1976–79 VS 1983–86

(SHARES OF GNP)

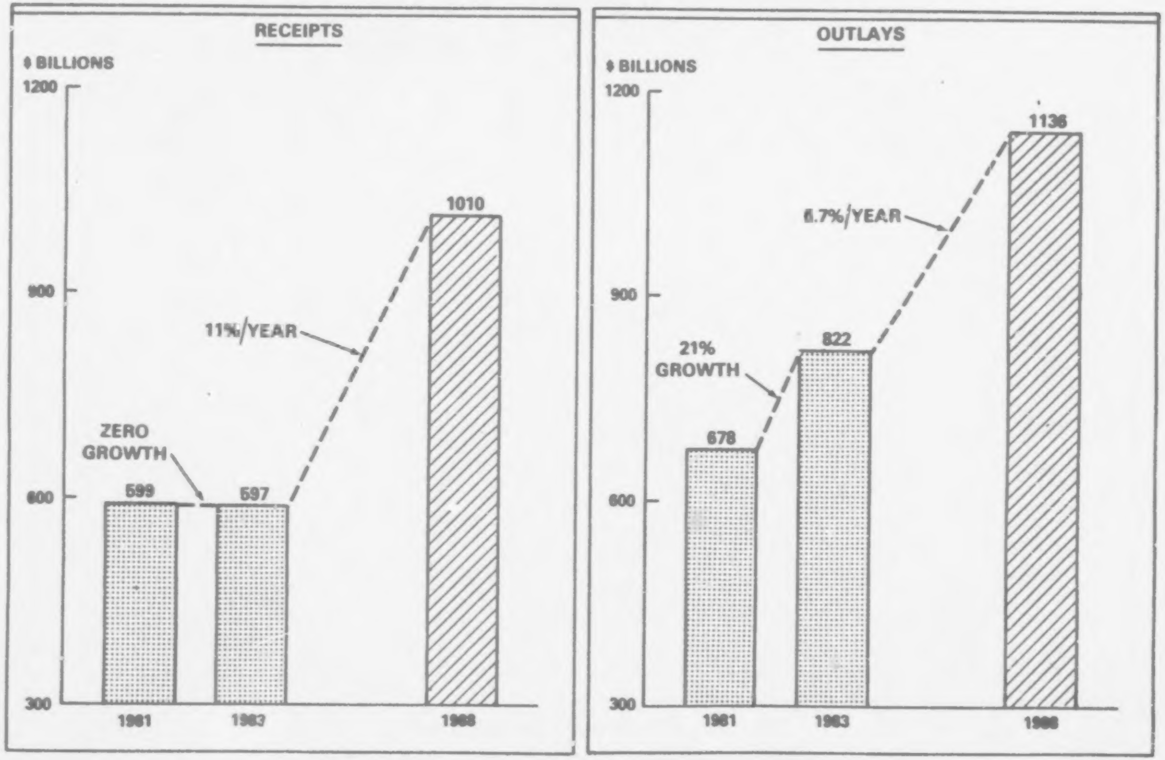


REDUCED SENSITIVITY OF BUDGET OUTLAYS TO ECONOMIC RECOVERY

(SHARES OF NONDEFENSE SPENDING)



IMPACT OF 1981-83 REVENUE STANDSTILL ON OUT-YEAR BUDGET TRENDS



INTEREST RATES

Chairman DOMENICI. Let me ask you a question about interest rates. I am not sure you have the answer but there has been a lot said about how much interest rates have dropped. I am concerned about the fact that interest rates that affect the average person have not dropped at all. In January 1982, the interest rate on 91-day Treasury bills was 12.5 percent. They are now at 7.6 percent. That is almost a 5-percentage point drop. The prime rate was 15.75 percent, now down to 11 percent. That is almost a 5-percentage point drop. Mortgage interest rates were 17 percent, now down to 13 percent, about a 3.1-percentage point drop. But consumer loan rates, auto rates other than those promoted by auto companies themselves and all others are still very high—they were 17.3 percent and they are now down only to only 15.9 percent. All others were 19.5 percent and they are only down to 18.33 percent, 1.2-percentage point drop.

Do you have any thoughts as to why that is occurring?

Mr. STOCKMAN. Mr. Chairman, I think you might want to quiz Mr. Feldstein more about that. I think he will probably give you a better answer.

It is only my observation but the most volatile rates, those most flexible and that move the greatest, are the open market, overnight deposits, T-bill and commercial paper and when you get into the commercial lending level, rates do not go up as much as the interest rate rises, nor do they come down as much as the open market rates fall. That is for a whole variety of reasons having to do with market factors, having to do with risk and so forth. I am not sure there has been more or less change given the historical change of interest rates at the retail and relative to what has happened in the open market.

Chairman DOMENICI. You would agree that consumer loan rates and all others have to come down appreciably if we are to get——

Mr. STOCKMAN. I would agree, and there is one exception, mortgage rates which have come down rather substantially from the 18-percent range, 17 percent on FHA, into the 13-percent range now. So that is one area where the consumer rate has come down. We are beginning to see the results with housing starts and permits in the 1.3, 1.4 million range.

CONSTRUCTION-TYPE PROJECTS

Chairman DOMENICI. With reference to construction-type projects that are in this budget, does this budget fund highway construction to the maximum in the law?

Mr. STOCKMAN. I would say very close, $1.4 or $1.5 million a year out of a $12 or $13 million bill.

Chairman DOMENICI. And last year airport construction and renovation received a new lease on life with some additional user fees. Is funding increased in this budget for that?

Mr. STOCKMAN. Yes, $700 million for airport grant program which is a $100 million last year and $250 million more than the year before and it goes up to $800 million or $900 million.

Chairman DOMENICI. Are there any other programs of that type that are funded in this budget so that we have some idea of how much construction-type money goes into the normal pipeline?

Mr. STOCKMAN. Well, Mr. Chairman, overall, if you would take what I think could be described as public infrastructure spending and investment, mass transit, highways, airport grants 'the FAA capital investment program, waste treatment grants, water resource projects, Bureau of Reclamation and Corps of Engineers and community development block grants, $35 billion in this budget for 1984 compared to $26 billion in the budget for 1982. So we have something in the order of a 40-percent higher level of investment in this budget for public infrastructure than we had just 2 years ago. But more importantly, we have funded it through increases in user fees and thereby have not contributed to worsening the deficit even as we have tried to meet substantially higher funding levels and needs in these areas.

FUNDING LEVEL FOR DOMESTIC DISCRETIONARY PROGRAMS

Chairman DOMENICI. One last question. Last year in the compromise with the White House on a new budget there was a level of funding for domestic discretionary programs, I do not have the figures, maybe you can remember them. It was substantially higher than the administration wanted in their original budget. It ended up finding itself appropriated in the continuing resolution for the year plus whatever individual bills we passed.

Now is that the level that you have used when you say we are freezing domestic programs?

Mr. STOCKMAN. Yes. What we have used is the actual budget authority enacted for the ten domestic agency bills in 1983 and the appropriations process plus the obligation level for programs that are funded out of trust funds where obligation levels control rather than new budget authority. There was $130 billion in the 1983 congressional act. We have $131.5 billion so we are right about at that level.

Chairman DOMENICI. How much of that $131 billion would be used up by newly appropriated initiatives that are in your budget?

Mr. STOCKMAN. Well, most of the new initiatives in our budget really are ongoing activities funded at a higher level. We had the major drug and crime control initiative appropriated last fall. That is funded at a somewhat higher level in the budget for 1984. We have a major increase for National Science Foundation, major increase for Head Start, but it is not really new initiatives. It is expanded programmatic levels from those programmed in the budget last year.

DOMESTIC FREEZE NOT A FREEZE

Chairman DOMENICI. I note a headline, and I did not read the story, but the headline was "Domestic Freeze Is Not a Freeze But Negative 4 Percent."

What is that about?

Mr. STOCKMAN. I think that they are referring to it in real terms, that if there is roughly $500 billion in this budget for nondefense, noninterest, and there is, it is $500 billion flat, and the inflation rate is 5 percent, then somebody has concluded that it is a 4-percent cut. But actually, as you know, the freeze measures apply separately to all kinds of different programs in different ways. Some go up even with the freeze. Social security goes up $10 billion, even with the COLA freeze. Medicare goes up some $6.5 billion even with the reimbursement freeze. But overall in nominal terms it is flat and if someone wants to say that that is a real cut, then that is mathematically accurate but we have suggested otherwise. The Congress last year froze discretionary programs in nominal terms, not real terms, nominal terms, and what you implied in your budget resolution that Senator Chiles has mentioned is that you wanted to cut discretionary spending 5 percent in real terms for 3 years. That is what your freeze did. We have reflected that in our budget but now I hear people suggesting we cut discretionary programs too much but we only stayed within the budget resolution that was approved last year.

Chairman DOMENICI. Senator Chiles?

INFINITESIMAL DIFFERENCES BETWEEN ADDITIONAL REVENUES

Senator CHILES. In listening to your sort of rebuttal, Mr. Stockman, you started off talking about infinitesimal differences between the additional revenues, where you will end up in 1988 if the contingency tax is approved at 2.6, and where you would be—and where you were in 1981 with what revenues were at that time. So you were pointing out that is an infinitesimal difference. But that difference is pretty big depending on when you put the mix in. Your taxes only come into the 2.6 in 1988 but in the meantime your own charts show that we will have a net interest in 1988 of 3.4 percent and that is an increase of 1 percent from 1981, from actual interest, 2.4 to 3.4 percent and that is certainly—that interest rate up there, 3.4 percent of GNP is going to haunt us a long, long time in regard to that national debt because we are waiting that long to get any additional revenues.

Mr. STOCKMAN. Well, that is a serious problem and I think it is proof mathematically that you cannot fund the Government on bonds forever or you eventually go bankrupt paying the carrying cost.

But the point I was making is the standby measure is implemented, then we will have in the aggregate in the economy a tax burden that is nearly as high, three-tenths of 1 percent of GNP difference, as it was in 1981 and everybody on this committee in 1981 felt existing tax burden was too high and that it needed to be reduced.

Now you had different ways of doing it but I do not know of anyone who suggested that we needed to have a tax burden at 22 percent or 24 percent of GNP and so, therefore, what I am suggesting this morning is if you think you need $50 to $100 billion a year in revenue beyond what we have in here, you are advocating tax rates and tax burdens on the economy that are higher than what we started with, not taking back the cut, but are actually higher than what we started with and the economy was not performing very well when we started.

Senator HART. Would the Senator yield?

The situation is not the same, Mr. Stockman. The last Carter deficit was $59 billion, remember, the one that cost him the election. You use the phrase "fiscal problem." Well, this fiscal problem is not the same one we had in 1980.

BUSINESSMEN CONCERNED ABOUT DEFICIT

Senator CHILES. As I recall, one of the main reasons we were talking about the 3-year tax cut, if we put it in effect immediately, was so businessmen would be able to plan. If businessmen had the opportunity to know what their tax structure was going to be, then they would make the kind of investments we needed I remember Arthur Burns used to talk about a 5-year tax cut phased in slowly. I wish we would have listened to him then because that would tell the businessmen what the route is going to be, tell him what his taxes are going to be over the next 5 years and you could afford to phase it in gradually because he will make those kinds of business decisions. Granted, that was one of the reasons for this 3-year tax cut. Then the contingency tax flies right in the face of that. What is that businessman supposed to think or know now? Maybe it is going to be there or maybe not.

You said, I do not remember the exact remarks, but if it followed any historical perspective, it would be in and what the President said 2 days ago, was no way that contingency tax cut will be there. You do not have to worry about that.

So you are speaking one way and he is speaking another. What the hell is that businessman going to think about that?

Mr. STOCKMAN. The overriding concern to the businessman is the deficit and whether or not interest rates are going to come down and stay down. It seems to me that you would like to reduce uncertainty in the world to zero but you do not always have that choice and in this case the certainty that there will be some kind of cap on the deficit, the assurance that you will provide to financial markets that we are not going to get into a radical reflation situation and print the money after the recovery begins to finance these deficits and rekindle inflation is probably the most important thing we can do. It is not ideal but it is far better than doing nothing at all.

FUNDING FOR SCIENTIFIC RESEARCH INCREASED

Senator CHILES. I just cannot understand why it was so important back at the time we were passing the tax cut and now we are putting uncertainty in there. One of the things that I think many people have applauded your budget for, and I certainly do, is that it recognizes the importance of funding for scientific research. You have made an increase in that. As I started reading, I found out you have only done that for 1 year. What kind of signal is that going to send to the Rand Corporations and the universities and to all of the other people and endeavors that are engaged in research, if we are talking about beefing up our scientific and technical research but only for 1 year?

Mr. STOCKMAN. Well, I am not sure what you are referring to there. It was my impression that we raised the level of National Science Foundation to $1.2 billion and I do not believe we cut it after that. I believe the budget will show a continuing trend.

Senator CHILES. You froze it.

Mr. STOCKMAN. At $1.2 billion?

Senator CHILES. Yes.

Mr. STOCKMAN. There is a small erosion then, right.

GROWTH OF DEFENSE BUDGET AFTER REMOVING EFFECT OF INFLATION

Senator CHILES. The last question I would like to ask on this round is in our defense area, the growth of that defense budget after removing the effect of inflation, we had 12 percent in 1981, 11.2 percent in 1982, 9 percent in 1983, and 10 percent in the 1984 request. Then the Department estimates there will be 11-percent real growth in 1985 but then the Department says those requests are going to be down to 4 or 5 percent so that by outyears 1988 and after, we are going to see only about a 7-percent real growth rate.

Now every year it seems like the administration comes in with a request of high rates of real growth with a promise of lower growth in the outyears. I am wondering, are we ever going to get to the outyears? Given what is happening in our weapons systems where we underestimated costs, it looks like no provisions are in to try to really take a better look at that. Are we ever going to get to outyears or are the outyears always going to be out there and aren't we going to find that those costs, 10 or 11 percent, are going to continue?

Mr. STOCKMAN. Well, Senator, I think it depends on how we conduct ourselves in the inyears. If we simply indulge in some kind of mindless irrational hacking away at the defense budget this year because people want to get the numbers down because suddenly that has been identified as the source of the problem, what you will end up doing is not cutting any weapons systems but just stretching them out because no one wants to give up the weapons systems. They just want to reduce the money in the budget. If you do that you will end up probably substantially increasing the life cycle cost of the systems and that is one probability, that is one possibility, that could happen and your outyear increases then would continue to be as large as these we are having so much difficulty with now.

So it seems to me the answer to your question depends on whether we handle things in the right way this year and next year.

Senator CHILES. Doesn't the answer really depend on whether we are going to determine whether there is anything to historical perspective? This historical perspective has shown that those weapons systems have always cost more.

Mr. STOCKMAN. Because historically we have always reduced the production schedules, stretched them out and done things that have increased their unit cost substantially when we got into a budget bind or we wanted to spend money for something else.

Senator CHILES. I do not think history will show that is the only reason.

Mr. STOCKMAN. That is one of the major reasons that I think can be demonstrated fairly clearly.

Chairman DOMENICI. Senator Symms.

LONG-TERM CAPITAL MARKETS

Senator SYMMS. Thank you, Mr. Chairman.

Thank you, David, for your ability to have a handle on all these questions in the budget. I marvel at your understanding of what our problems are.

One of my major concerns, which I spoke to a little bit earlier, is that we have witnessed in the last few years our long-term capital markets have shrunk from what used to be 30-year markets to 10-year markets or even less and the private sector seems to be unable to finance their present debt and their future growth.

How much do you relate and tie the long-term capital markets to—and the restoration of those markets, which I believe are imperative if we are going to have economic recovery and sustain this growth, that we need to have to get out of the budget mess we are in. How are we going to do this without a drastic, and I do not mean that I am not happy that the President made some timid or meager, I should say, suggestions that slow down COLA's for the future but, I mean, without a drastic change on our approach on the COLA's, which take up 50 percent of the budget, I mean, the entire entitlement question, how are we ever going to restore long-term capital markets?

Mr. STOCKMAN. Well, Senator, I know what you are saying and I think you made some very good points before but I have come to the conclusion that there is nothing drastic that can be done about this budget that there is a consensus for and that is right. We cannot do anything drastic in defense or we are going to pay a serious price. If we do something in taxes, 3 or 4 years later the economy will be reeling and even in the area that we have to get to, domestic spending, which is still too high in the COLA's you mentioned, if we do something drastic there, it will not get done. It is only a paper proposal and it probably would not be right and here is why I said that. You mentioned a moment ago, let us freeze COLA's until we get things under control. If we froze COLA's and pay, every indexed check to an employee or beneficiary of this Government, for 5 years, not 6 months or 1 year but for 5 years, we would save $100 billion in 1988 and the baseline deficit would decline from $315 to $215 billion. That would not solve the problem but in the interim people would have had their standard of living cut by 25 percent. I do not think that we want to cut social security standard of living by 25 percent or even the Federal pay level by 25 percent if we want this Government to function.

So even in that area, as critical as it is, to get some kind of constraint and cap on these COLA's, the drastic solution does not solve the problem and the drastic solution is wrong. Our particular dilemma at the present time is to find some way where we can find a part of each of these solutions and put it together in a package that gets us through.

Chairman DOMENICI. Would the Senator yield?

Senator SYMMS. Yes.

SAVINGS FROM FREEZING ENTITLEMENT PROGRAMS

Chairman DOMENICI. Mr. Stockman, do you have a number that in the $580 billion deficit reduction package that is made up of reductions in growth programs and revenues? Do you have an estimate as to how much of that saving, over the 5 years, is attributable to entitlement programs by way of freezes, or reform?

Mr. STOCKMAN. Yes, just on the COLA's and pay alone, it is $77 billion, and then if you add medicare and medicaid to that, it is $28 billion more, and civil service and military retirement reform, $16 billion more, means tested entitlements, which I am sure we will be discussing later, $14 billion more, or 5 percent of current law spending for those programs. So if you add all of that together, plus some minor items I may have overlooked, it sounds to me like you have $125 billion——

Chairman DOMENICI. $135 billion.

Mr. STOCKMAN. $135 billion package of entitlement reforms in this budget.

Chairman DOMENICI. Now, the point you were trying to make with the distinguished Senator was that while he is talking about multiyear freezes of indexed or COLA programs, if I read you right, you are saying you have $135 billion, and it is obvious that that is going to be hard to get.

Mr. STOCKMAN. That is right, and I was addressing the particular point that let us just freeze COLA's and pay for 5 years, and that will not even begin to solve the problem.

CONFIDENCE NEEDS TO BE RESTORED

Senator SYMMS. Mr. Chairman, the point that I think we are missing is that the reason it would begin to solve the problem is because the premise from which you are working is a baseline that I think would not be the reality if once the financial markets, the people in the country, have confidence in Washington, like the newspaper reporter who I alluded to earlier in my remarks—once those people out there have confidence that we are finally going to do what is right, we would find ourselves with surpluses coming in, because once the engine of the economy starts working, there will be more revenues.

The premise we are working from is we have to do what is necessary to make a true restoration of confidence, and what I see that the public is interpreting is that Ronald Reagan came to town with great hopes and aspirations for the country, and now it has become President O'Neill's budget, and that is what the financial market has been concerned about for the last 10 years, and so we are not getting the message through that has to be gotten through to mainstream America, so people are willing to take a risk and expand their business, and hire more people.

FREEZING COLA'S STILL LEAVES $100 BILLION DEFICIT IN 1988

Mr. STOCKMAN. Steve, if I could respond to that.

Again, I appreciate the fact that the more we do, the better off the economy is going to be, the better the growth rate is going to be, and the more the deficit will shrink automatically. I agree. But still the math is going to say something different, and I hope you appreciate that.

If you froze COLA's for 5 years, in 1988 you would save $100 billion. Then as a result of that, the favorable signals to the market, lower real interest rates, you get 1⅓ percent higher growth each year than we are projecting, 5⅓ percent real growth from now to 1988, or 6-year growth vote that never has happened before in history, you would have $120 billion in savings by 1988. So you still have $100 billion deficit left by 1988, even if you had 1.5 percent growth, and freeze on COLA's.

Senator **Symms**. There would be other areas. It cannot all come out of COLA's, and I would not even advocate freezing the low-income recipients of some of these transfer payment programs for 5 years, because I think you do take Aunt Farrah, or someone out here who lives on a fixed income, $300 or $400 a month, and sole source of income—I think that would be exceedingly unfair. But there are many millions of Americans that receive $15,000 a year from the Social Security Administration, for instance, tax free, when the people working are not making $15,000, and we are talking about raising taxes on them.

We have heard from the White House, and from the other side. It seems to me if we make the bold move now—you are the one that advocated an economic Dunkirk in 1981. You were right——.

Mr. **Stockman**. I did not advocate that. I said it would result if we did not do the right things.

Senator **Symms**. You advocated bold and drastic moves. If we had done that, this would be over now. It is getting harder and harder to get it over with. We better not put this thing off think we are going to bet a consensus, because there would not be anything left out here to have political consensus with, if the public misinterprets what the goals and aspirations are of this administration. That is really my concern.

Chairman **Domenici**. Your time is up, and I gave you the 2 minutes I stole from you, and I apologize.

Senator Metzenbaum?

FAIR SOURCES OF REVENUE

Senator **Metzenbaum**. Thank you.

Now, you have heard from the far left and the far right.

You indicated that this committee has put their staffs together to find some things no matter how small and insignificant.

Frankly, Mr. Stockman, I think it is an unbecoming statement. It is out of line. We are talking about 23 million people unemployed. I think that is unfair. Billions of dollars, and where you come off the wall with that statement, I do not understand.

Now, I think that I would like to ask you the question as to your indication that because Senator Johnston and I are claiming you, that you are losing your position. Assume for the moment that you came to work for this committee on this side of the aisle, and we said to you that we want to look at the revenue side, not in 1986, 1987, and 1988, with a $30 billion a year tax on people buying gasoline, 12 cents a gallon—not that kind of a tax, but on the basis of trying to provide the income necessary to balance this budget, what would you say to us if you were working for us?

You have been in the Atlantic Monthly article indicating tax loopholes. In the New York Times, front page, recently, it indicated that you were in disagreement with the administration with respect to the revenue aspects of the budget. Will you tell us what you would advise us, assuming you were not speaking for the President, but speaking for those of us who are looking for sources of revenue that are fair?

Mr. STOCKMAN. Well, Senator, given the expert job you have done working me over on this committee, on three or four different occasions, I conclude that you must have a top notch staff already, and I doubt whether I could improve on their recommendations.

Senator METZENBAUM. Having said that, I am sure that you have advised the White House, and others in the administration, that there are areas in the revenue side that could be used. You would agree, I am sure, that if we are going to do something about solving the problems that Senator Symms and others have been talking about, that we ought to do it now. He may do it in a different way.

If we are going to look at the revenue side, it ought not be in 1986 or 1987, regardless of the solution. If we are going to do it now, should we take a look at the fact that we reduced the maximum tax almost 30 percent for anybody earning over $85,000 a year? Should that be an area we ought to look at?

REDUCING CAPITAL GAINS MOST IMPORTANT CHANGE

Mr. STOCKMAN. Well, I think I would take very strong exception to that. Of all the changes we have made on both sides of the aisle, reducing capital gains is probably the most important thing we did.

Senator METZENBAUM. I said reduce the maximum from 70 percent to 50 percent.

Mr. STOCKMAN. It seems to me that was something offered by the chairman of the Democratic Study Group in the House, and supported broadly on both sides of the aisle.

Senator METZENBAUM. I am not questioning the Democrats or Republicans.

Mr. STOCKMAN. That was a very good change, because a 70-percent rate just encourages shelters that are inefficient and wasteful economically.

Senator METZENBAUM. That costs about $15 billion over the next several years.

Would you change the estate tax to the point where only three-tenths of 1 percent of the estates in this country will be paying any taxes as a consequence of the changes we made, and that will cost us—that is about $15. The 70 percent is about $6 billion.

Would you change the gift and estate taxes in the 1981 bill?

Mr. STOCKMAN. I do not have particular expertise with that bill, but it is less than 1 percent of the deficits we will be facing over the 5 years. Whether we want to undo all that is something you might want to look at, but I doubt whether it would be wise or helpful.

Senator METZENBAUM. Do you think we went too far into the ACRS?

Mr. STOCKMAN. That was corrected last year by the tax bill, last summer.

CORPORATE PROFITS AS SHARE OF NATIONAL INCOME DECLINING

Senator METZENBAUM. It will still cost $126 billion in the next 5 years, and it is part of the reason that 50 percent of the corporations will not be paying any taxes by 1985, according to the letters sent by 16 Republican Senators, to the President.

Mr. Stockman. I noted your chart[1] with care, and I had not seen those numbers before. I think you left the payroll tax out of your chart, in terms of where the revenues come from in the Government.

Senator Metzenbaum. What do you mean, payroll taxes? Social security tax?

Mr. Stockman. That is right.

Senator Metzenbaum. I said that. Excluding that. I said that in my statement.

Mr. Stockman. My point is that I do not think you can squeeze it out of corporations, even though there may be some substantial inequities, or provisions of the law that are not productive. But the reason the corporate share of the Federal revenues keeps going down is that corporate profits, as a share of gross national product, keep going down.

Senator Metzenbaum. I do not think that was the fact until the last 2 or 3 years of this administration.

Mr. Stockman. No, no. I will send you some statistics this afternoon, which will show that over the last 30 years corporate profit share of gross national product has suddenly declined, and explains two-thirds to three-fourths of the decline of corporate revenue.

[The following was subsequently submitted for the record:]

Period	*Corporate profits before tax as a share of GNP (percent)*
1950–59	11.6
1960–69	10.1
1970–79	9.2
1980	9.2
1981	7.9

Senator Metzenbaum. Are you saying the only way we can look at the revenue side, this will be my last question, Mr. Chairman, is by looking at either a tax on unemployment benefits—a tax on——

Mr. Stockman. No.

Senator Metzenbaum. Tax on medicare expenses of employers—medical expenses of employers, a tax on consumption, which is one of the things that President Reagan has thrown up as a balloon, a tax on oil, which is—and standby tax, or a third tax on the income tax?

There is no other way we can go back and look at the inequities, and close some of the loopholes?

Mr. Stockman. I am sure, as Chairman Dole said, there is more that can and should be done. But we made a major change and, as I remember, you agreed with the $235 billion of tax reform over 5 years which was enacted last summer.

I would note the surcharge, if that is what the Congress chooses as the standby measure, however you define it, is about as progressive as they come. It is a surcharge on liabilities, and the higher the liability, the more you pay.

In terms of other measures, I am sure you will find mixes to look at, but I cannot provide any comments right now.

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[1] See p. 22.

Senator **Metzenbaum**. I think my time has expired.

Thank you. Mr. Chairman.

Chairman **Domenici**. Senator Grassley?

INDEXING

Senator **Grassley**. Mr. Stockman, I do not have a question, but I do have some comments in regard to indexing.

I think it is probably going to be an issue before we are over the budget. It is probably going to be raised by the other side of the aisle and, frankly, I do not know why it is going to be raised, other than it may be a way of avoiding the real issue of whether or not we ought to have a tax increase or not. But my advice is that we should not concentrate on the issue of indexing.

Whether or not taxes ought to be increased or not, because people like Senator Armstrong and I did not promote the indexing concept as a goal of reducing taxes, even though that hopefully will be the end result—but because we wanted to make future Congresses more responsible on the level of income, which then can be expended in the budget, and we feel that indexing, you know, through the automatic increases then never makes Congressmen face the issue of raising taxes, and indexing does not start until 1985, and why should we be making an issue out of indexing this year, if something needs to be done about increasing taxes in 1985.

Then we ought to wait to a closer period of time to do that, and you do not have to, if you want to raise taxes, do away with indexing. All you have to do at that time, whenever this Budget Committee and the Finance Committee, which I am also on, and the Congress as a whole, makes a decision that we need more revenue, then let us vote on more revenue, but let us not do it indirectly through the way of indexing, and I think at that point that each Congressman who thinks we ought to be spending more, ought to be on record.

I may be one of those, but I do not think it ought to come in this roundabout way, so I suppose the message I would like to give you, and the White House, is they approach it that we should not be doing business as usual, that these economic times are such that the bottom line is that things ought to be done different and in a more responsible way, and that the White House would fight the indexing issue on the principle of Congress being more responsible, and should be raising taxes directly and not indirectly, except the extent to which we feel economic growth brings in additional revenue, which I find no fault with.

BUDGET CRITICIZED FOR NOT DOING ENOUGH ON REVENUE SIDE

Mr. **Stockman**. Senator, I agree with you strongly. This budget was criticized as not doing enough on the revenue side, even though the tax claim on the economy will be the nearly the same as it was in 1981. What is implied in that statement is that we should have allowed the old law to stay in place without indexing, so that the tax burden in the economy could continue to rise automatically without a vote of Congress. It also implies additional tax revenue that now somehow has disappeared, and that people want back, should have been taken from the American people without anybody here having to stand up and say whether they are voting a red card or a green card on that proposition. That is not right.

If we are going to want more Government, then we should vote the taxes. We should not try to put them in through the back door with the kind of tax system we had prior to 1981.

Senator GRASSLEY. I suppose additionally for me to be totally consistent, as far as when we ought to make a decision on the tax increase, as the time comes when you are closer to it, inferrentially with that, I am not sure that now would be a time to make a decision on standby taxes.

I have not thought that through totally, but I think that at least preliminarily that would be my view.

You do not have to comment on that.

Thank you, Mr. Chairman.

Chairman DOMENICI. Senator Johnston?

BALANCED BUDGET AMENDMENT

Senator JOHNSTON. In 1981, this committee recommended that we cut entitlement COLA's to the lower of the consumer price index or the wage index. The Senate endorsed that, sent it to the President, and he turned it down, for whatever reasons, I do not know.

I believe that you were one of those in there strongly arguing with the President that he ought to accept that, and he said no. This year he chooses not to cut social security COLA's other than the 6-month delay and you say that it would be unfair to do more, and even if you froze all COLA's for 5 years, along with wages, that it would only save $100 billion by 1988, and would not solve the deficit problem.

So much for entitlements. We cannot do it, or we would not do it, with entitlements. We should not do it with defense, because the Russians are coming, or whatever it is. We cannot do it with net interest, and certainly not with all of the remainder, which is only 16 percent, which is all the other budgets, social programs, et cetera. We tried to do it with that part, and we saw that that did not work, and I look at your budget, and I see deficits as far as the eye can see, in 1988 of $117 billion.

My question is, Are you still for the balanced budget amendment?

Mr. STOCKMAN. Obviously, that would be a desired state. When we get there is the open question.

Senator CHILES. It is in the outyears.

Mr. STOCKMAN. 1988 is one of the outyears.

BALANCED BUDGET AMENDMENT WOULD CREATE TOUGHER DECISIONS

Senator JOHNSTON. To be quite serious, as someone who is a true believer in that foggy, murky concept of the balanced budget, just what would you have done with a balanced budget amendment had it passed, been ratified by the people, and let us say it kicks in in 1986, when you project a $148 billion deficit. What would you have done?

Mr. STOCKMAN. We would have had even tougher decisions than we faced.

Senator JOHNSTON. You do not like 1986. How about 1987? That is a $187 billion deficit.

Mr. STOCKMAN. I am not sure how you want me to answer that question.

Senator JOHNSTON. I said at the beginning, if wisdom is to be honest—you were quoted by Secretary Regan, when all else fails, be honest.

Honestly, what would we do if we had a balanced budget amendment in place?

Mr. STOCKMAN. Let me say that I believe a balanced budget amendment is a good idea. If it were in place, we would have to do some things that would be very disagreeable, that we are not discussing this morning.

Senator JOHNSTON. What?

Mr. STOCKMAN. I think we ought to work on getting the budget deficits down, at least to the paths that we have shown in this budget, since we are not constrained by the amendment. If we can get that far, then we will have plenty of time to do more.

Senator JOHNSTON. You say if we had the balanced budget amendment we would do things that we ought to do that we are not doing.

Mr. STOCKMAN. I do not think it is a matter of if we had it or not. We have a financial market that is scared to death of these deficits, and rather than have an academic debate about precisely the last incremental measure you would take to get to zero, it seems to me the threat is $315 billion baseline deficit. The threat is deficits amounting to 6 or 7 percent of GNP. If we get real action this year, and deficits head to 2 percent of GNP, we will abate the worries in the money market enormously and get some real controls. Where that deficit comes out is anyone's guess; I think it would vary.

CREDIBILITY OF ADMINISTRATION ON BUDGET PROJECTIONS

Senator JOHNSTON. You are now projecting a $208-billion deficit for fiscal year 1983 and as I recall, it was projected for less than $100 billion last year. What do you think the credibility of the administration is on budget projections?

Mr. STOCKMAN. About the same as the budget resolution, which had an estimated $104 billion. They were your assumptions. I tried to persuade you of mine but you rejected them. We proceeded with your assumptions of $104 billion. It turned out to be $208 billion because we were both drastically wrong about how long the recession would last and how rapidly inflation would fall.

SENATORS JOHNSTON AND NUNN PROPOSALS

Senator JOHNSTON. I believe that we ought to be doing those things that you say we are not talking about. I proposed such a plan last year, Senator Nunn and I proposed it. We got support on both sides of the aisle and I suspect—I thought it had a real chance to pass. In it, we would have suspended the third year of the tax cut. We would have cut defense. We would have restrained programs across the board, entitlements COLA's to the 4-percent GNP growth rate projected for 3 years, and it would have worked by

1985 or at least those were our projections and I thought it was realistic. I think we ought to have the same kind of effort this year and do away with what I see—you cannot have it both ways. You cannot say you still believe in the balanced budget and go out on the front steps of the Capitol and have the big ceremony and then come in with these kinds of deficits. You have to be honest and say we do not believe it anymore, if this is what you project. If it is not, let us get some real action. You will get some support on this side of the aisle, maybe not even half, but enough to pass it. I think you ought to try and I really believe that is what you believe, that we ought to try.

Speaking of this tax business, by the way, some of us Southern Democrats were in with the President back in 1981, before the time he was trying to pass this tax bill. I argued to him that I thought it ought to be triggered into the performance of the economy. I think you might have been there. I know Regan was there and Regan threw up his hands, "No, with all of the confidence of Merrill Lynch and bull markets, no. Wall Street is expecting these cuts and they have not gone into the law for 3 years" and the President sort of nodded.

About that time Russell Long said, "Mr. President, I am not going to insist on having these cuts triggered into the performance of the economy. But I will tell you that, I have been around here a long time"—with that little smile and twinkle that Russell has. "I know if it does not work out, you will be the first to propose a change."

I thought to myself, that old fox, he has been around a long time and he knows that.

Sure enough, it did not work. But, you know something, the President did not propose the change. Now we are waiting for, maybe this is it—a mid-course correction—but this is not much of one. We need to steer the ship back to that oldtime religion, back to the balanced budget, and that starts with suspending the third year of the tax and a little defense decrease. I can read figures, not as well as you can, but I can look at a doubling of military procurement costs over a period of about 3 years and I would say that this is a pretty good increase. But you cannot say that it is sealed in law. You can stop the B-1 bomber. That is $40 billion. You can stop some of the other programs that do not contribute to our defense but make some contractors happy.

Senator Chiles. I like your note, you can read figures but not as well. It reminds me of my constituent who said I do not know much, but what I know, I know as good as the next man.

Senator Johnston. Someone has passed me a note about the out years. It is like the joke Mo Udall tells about the old Dodger fans. Each year they get more anxious about beating the Yankees and every year they say "Wait until next year." Finally, they had a real good chance and they put up a sign which said, "this is next year."

I think this year ought to be the out years. It is the out years from about which we used to talk. It is time to take some action, I think.

Chairman Domenici. We will be anxiously looking for your balanced budget proposal.

Senator JOHNSTON. Would you join me?

Chairman DOMENICI. I did not say that. I said I would be looking for it.

Senator Kasten.

SOCIAL SECURITY TAX INCREASES WILL COST JOBS

Senator KASTEN. Mr. Chairman, it is clear that we will have to make changes in defense, and I think you will have bipartisan support for that effort. We all recognize that the administration has given us a little bit of a window for that.

David, our No. 1 priority must be to putting people back to work. The sooner we do that, the better off the country will be.

This morning's Washington Post quotes you as expecting 4.6 million jobs to be generated over the next 2 years if your budget is approved. This budget package includes the social security tax increases. The DRI study done for the Chamber of Commerce of the United States says that those social security tax increases will cost 2 million Americans their jobs over the next few years. Does the estimate you have for 4.6 million new jobs take that into account? And if we can find another way of solving the social security funding problem, would you say that this budget would provide 6.6 million rather than 4.6 million jobs?

Mr. STOCKMAN. Well, let me respond by saying if I recall that study, it was based on the assumption that 1990 rate would be moved all the way forward to 1984. That would be a huge tax increase; what is proposed in this package is something drastically different. It moves the 1985 rate forward to 1984 which causes a net increase in the tax burden of $5.5 billion. There is a credit for the employers' share of the increase. Little or no change in the rates take place in 1985, 1986. So you are talking about a 3-year period in which we will have $10 trillion worth of GNP and $5.5 billion worth of tax increase. I do not think you will have any effect whatever on the course of the economy.

Senator KASTEN. As you know, Senator Armstrong and others are trying to work out alternatives but your $4.6 billion figure assume that we have social security tax increases as——

Mr. STOCKMAN. Yes, because in the next 2 years, if I can state it again, there is only a very minor increase in the payroll tax that is not offset with an increase in income tax credit.

Senator KASTEN. But you are not denying that whatever tax increase we have got, maybe a third of this or whatever, is going to cost jobs in the process, but your 4.6 billion figure assumes that we will have the social security package that we had before?

Mr. STOCKMAN. That is right.

ADDITIONAL 1 PERCENT ECONOMIC GROWTH

Senator KASTEN. On page 8 of your prepared statement [1] you have got the 1-percent increase in economic growth showing the lower deficit track. If this is our goal, what fiscal and monetary policies should we enact to insure this? Howard Baker is working to put pressure on Volcker to keep monetary policy from becoming too restrictive. I know that you are not the pro on monetary policy, but what should our monetary goals be assuming we want to get this additional 1-percent growth? What fiscal policy should we be using to complement this action?

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[1] See p. 41.

Mr. STOCKMAN. I think I would respond by saying the monetary policy we have now can accommodate a 4- or 5-percent real growth rate over the next 6 or 7 quarters. That is what that dotted line implies, not 6 years, but 6 or 7 quarters. No one really has a crystal ball that is capable of determining whether it is 5 or 4 percent but we took a cautious approach and put it at 4 percent. We can improve the odds of coming in at 5 percent if we can demonstrate to the economy and the financial markets that we are getting together quickly, seriously, and credibly to reduce the deficit both now and in the future. I think that is the most important thing we can do. We do not have to send notices to the Federal Reserve. I think they are doing the right thing. We have to get the job done here.

Senator KASTEN. We have to reduce the gap between the prime interest rate and the real interest rate. That gap is historically 3.5 percent but has been significantly higher of late. I agree with the President that the financial community does not trust Washington to act responsibly. We have to turn these fears around.

Do you think that the deficits you forecast will allay their fears?

Mr. STOCKMAN. I think if you would look at the top line of that table, that is what they fear, a deficit of 6 percent of GNP or better. If you look at the bottom line, it will not allay all of the fears but it would certainly indicate that Government collectively was capable of getting finances in order and moving out of the financial markets in due time in order to permit the recovery and noninflationary monetary policy to continue. I think that top line spells "printing press" to the financial market. I think it indicates reinflation, sooner or later. That is why the so-called real interest rates, the long-term rates, remain high. Until we remove that threat, we are going to have a hard time allaying those fears.

ECONOMIC ASSUMPTIONS MAY BE TOO LOW

Senator KASTEN. I guess some of us are not as confident as you that that bottom line is enough to do it. Most economic forecasters are projecting higher real growth than you are. In post war history, average economic growth in the first 4 years of an economic recovery is close to 6.9 percent. It is very possible, isn't it, that the assumptions that you picked are too pessimistic? In fact, in your own words, you said that you chose not to overstate the case. In this morning's Post Feldstein is even predicting a good recovery, and speculates that the budget might be balanced by 1990.

What is the chance that the administration's economic assumptions are too low, too pessimistic, and that we will be significantly ahead of these assumptions?

Mr. STOCKMAN. I think you have to distinguish very sharply between the near term, 1984 and 1985, and the outyears, 1986 through 1988. There is a fairly decent chance that we could be too low as well as too high in the near term. The economy could be stronger. But the problems of sustaining that over 6 years, which is required, is significantly harder. To reduce that baseline deficit, I do not think the odds are high at all. I would refer you to page 43 of my testimony[1] because, if you look at that, you will see that there have been a lot of recoveries that have started stronger than we are forecasting.

Senator KASTEN. That's the 6.9 percent four quarters growth I mentioned.

Mr. STOCKMAN. If you look at this table, this is every recovery since World War II and you can see all the dotted lines there. It is a bit of mess in terms of the way they all interact but they all start at higher rates than 4 percent. But the cumulative rate of growth decays rapidly after the first four quarters. You can see that on the next page.[2] We compare our forecast of 4 percent against the actual growth rate in the 1975 recovery. It was stronger for the first 3 or 4 years and then decayed rapidly while inflation took off rapidly, as you can see in the box at the top of the page. In terms of the size of the outyear deficit 1986 through 1988, which is the real threat, what matters is the sustained growth rate between now and then and the level of GNP in 1988. It is not particularly important if whether we have a 5-percent, 6-percent, or 4-percent recovery for the first three or four quarters of this year. In other words, if we had a 6-percent recovery this year and nothing more, the deficit in 1988 would be about $290 billion on baseline rather than $315 billion. But if we had 5- or 6-percent sustained growth for 6 years, the deficit would come down by $180 to $120 billion in 1988. Odds of the latter happening are fairly low; odds of the former happening are reasonable. Who knows? We cannot forecast those things, but the point is the high probability outcome does not make the problem go away. Only the low probability outcome does that but I do not think we can use it to make policy.

Senator KASTEN. Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you.

Senator Riegle?

DEFICITS AND STANDBY TAXES

Senator RIEGLE. Mr. Stockman, in the first chart of your presentation, page 1,[3] budget totals at a glance, do the deficits in the 1986, 1987, and 1988—do they include the standby taxes?

Mr. STOCKMAN. That is right.

Senator RIEGLE. So this lead chart that you are putting out here builds in your judgment that we will have the standby taxes coming into play.

Mr. STOCKMAN. Well, the standby tax is premised on a deficit of 2.5 percent of GNP. Without it, the projection is above the assumption, assuming it goes into effect.

Senator RIEGLE. This may be the singlemost important thing in your document. Obviously, if you did not think you were going to need them, you would not put the chart together this way. You obviously reached the judgment, and I assume the President, that the standby taxes will have to take place and, therefore, they are built in your No. 1 summary chart.

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[1] See p. 76.
[2] See p. 77.
[3] See p. 34.

Now if that did not happen, am I right with the numbers that I have here, in 1986, if we were not to have the standby tax, that year the deficit would go up to $194 billion. In 1987, if we did not have the standby tax, that deficit would be at $171 billion and in 1988, that deficit would be $168 billion?

Mr. STOCKMAN. That is right.

Senator RIEGLE. So without the tax, without the tax increase in the outyears, about which there is a lot of skepticism, both in terms of the way it is put together and this administration pushing off the tax increase on a successor administration and so forth—if you do not factor that into your numbers, what happens to me is we plateau out at a very high deficit level, in other words, 1986-87 at $194 billion, the 1986 deficit would also be $194 billion, and when we get into further outyears, 1987 and 1988, it starts to drift down. But you and I both know the quality of the economic assumptions that far into the future do not mean a heck of a lot and a little bit of change can change the numbers. But I would say that that plateau of deficits is very alarming to me, if one takes away standby taxes that have been built into these bottom line numbers and I have not heard anybody support the standby taxes, frankly. Howard Baker spoke out against them and Bob Dole. I am talking about ranking Republicans in the Senate.

Chairman DOMENICI. I am for them.

UNEMPLOYMENT FIGURES FOR 1983 AND 1984

Senator RIEGLE. The chairman of the Budget Committee is for them but he is one of a few, if not the only, around here that is expressing that and other leaders, Senate Republicans, have come out quite strongly to the contrary.

But let me move to another point. The New York Times today, an article on page A-19, the headline, "Joblessness Causing Stress and Gloom About Nation" and then it is a profile of a lot of personal stories of people in terrible difficulty and I am sure you have been seeing, as I have, in The Washington Post and other newspapers and on television, scenes of literally thousands of workers, unemployed workers standing on line trying to apply for jobs that have come available. There was a picture from Chester, Pa., showing something in excess of 3,000 workers standing out in line and the line going over into the horizon as far as the eye could see in the cold winter, waiting to apply for something like 30 or maybe as many as 300 jobs. But it was a relatively small number of jobs relative to the number of people applying.

What do you show as an unemployment figure in this budget at the end of 1983?

Mr. STOCKMAN. At the end of calendar year 1983 it is over 10 percent.

Senator RIEGLE. How many people would that be, roughly?

Mr. STOCKMAN. Well, there would be about 100 million employed.

Senator RIEGLE. Ten million people?

Mr. STOCKMAN. In that range.

Senator RIEGLE. That is at the end of this year, 10, 11 months down the road. What about 1984, what figure are you projecting for unemployment at the end of 1984?

Mr. STOCKMAN. We are projecting 104 million employed, 11 million unemployed.

Senator RIEGLE. But the unemloyment projection——

Mr. STOCKMAN. Well, you have labor force growth in the interim so the unemployment rate at the end of 1984 is below 10 percent.

Senator RIEGLE. But what is it? You have got it there.

Mr. STOCKMAN. We have a practice which is observed by both branches of not putting out quarterly forecasts. But it is in the middle-9 percent.

HOW DO WE HELP THE UNEMPLOYED?

Senator RIEGLE. We will say 9.5 million people and this man would be unemployed at the end of 1984, which is almost 2 years from now, the fact that it is now February of 1983.

My question is this, and it is a very basic question. What do we say to these people and what are these people to do who are unemployed today, that are out there, who desperately need work, who cannot support themselves, cannot support their families, many of them have lost their homes and their cars, their asset base has been exhausted and truly they are desperate. They are showing up at feeding centers all across the country. I am talking about families, not displaced individual persons, but families with children, showing up not only for food but because they do not have a place to sleep. They literally do not have a place to get in out of the cold. There is a major problem for major cities to come up with shelters. What are these people to do?

Mr. STOCKMAN. I think the question is: What are we to do?

Senator RIEGLE. Yes. In other words, with this plan saying we will have 10 million people unemployed at the end of 1984, if we pass this whole thing today and 9.5 million unemployed a year further out at the end of 1984, what are these people in desperate circumstances to do right now?

PROJECT MINIMUM RECOVERY

Mr. STOCKMAN. It seems to me there are three things that we ought to do. First, to insure, by taking whatever steps are necessary, that the recovery that we are projecting is the minimum recovery, that we get a stronger recovery and that people are called back to work sooner.

Senator RIEGLE. But you are not projecting that?

Mr. STOCKMAN. We are not projecting that because during the last 2 years when I have come up here, we have had long lectures about the evils and about the misleading character of excessively robust or optimistic assumptions. So now we have tried to respond to that and come in with a middle-of-the-road recovery, which we think is possible. And my first point is to do better by attending to those things that Government can do to help a recovery improve.

INVENTORY ALL AVAILABLE GOVERNMENT HELP

Second, we ought to take an inventory of everything we have today in the Government that is available to help people who are waiting for their jobs to come back or who are in these conditions of distress that you have described, and we all know they exist.

Senator RIEGLE. Is that being done?

Mr. STOCKMAN. I would like to point out that we have $93 billion in the 1984 budget for the unemployed and low income.

Senator RIEGLE. The problem is it is not enough.

TARGET EMERGENCY RELIEF

Mr. STOCKMAN. The third thing is to ask whether it is enough and, if more needs to be done, how it can be done at a minimum cost and targeted to the very specific areas where it is truly needed. Now, we have come to the judgment that the $93 billion in the budget for 1984 and the $2 billion extra for extended unemployment benefits that we are asking for the remainder of this year on a national basis are responsive to the needs that are there. I am sure there are isolated localities—there are certain hard-hit places like Flint, Mich., or other places where troubles in the auto industry and steel industry have caused particular devastation—where money needs to be channeled or special efforts need to be made. I think if this committee comes up with something that is reasonable in its cost, targeted on the need, and not spread to every congressional district in this country, that there would be room in the budget for it. But if we make it just another grant to go to 435 House districts, where there are districts with 2 percent or 3 percent unemployment, we would not solve the problem because we will make the deficit worse and waste a lot of money in the process. So I encourage you, if you feel emergency relief is needed, target it to the one-third or 20 percent or 15 percent of the country where it is clearly demonstrated that need is being felt.

Senator RIEGLE. The emergency need is there and everybody knows it. The only people that do not understand it yet are folks at the very top of the administration. I do not think the President really does understand it and perhaps he would if he visited some of the areas where it is so and they can be felt in all 50 States. It is true it is in Flint but it can be found in every of the 50 States. That is what reality is. It bothers me—I like your suggestion that it is time to do an inventory of what the kinds of things are that might help. But that is another way of saying that has not been done and apparently is not being done and it should be done. Perhaps you can set it in motion, even if others are not prepared to do it. I would hope you would because I can tell you there are millions of desperate people out there of all ages who have fallen through the safety net, who have no income of consequence that they are able to draw upon, an increasing number that are homeless.

And I have seen a number of cases, a great number of cases where women are heads of household with children who are in this situation, showing up on the doorsteps of relief agencies that are not equipped to handle them. All across the Nation, Detroit, other places as well. We have to respond to that problem.

When the documents here concede the fact that we are going to have unemployment of over 10 million people at the end of this year, assuming that we do all of this, and nearly 10 million—in fact, more than 10 million actually in terms of members, a year further out, at the end of 1984, I think we have to start doing something to deal with the emergency problems. It is a huge missing part of the program, partly I think because the President does not want to believe it is so. I do not think he wants to feel that his program, a byproduct of it, is creating this human consequence. So he steers away from wanting to face up to it. We have to face up to it, and I think you can make that happen and I plead with you to make it happen.

HANDLE RELIEF EFFORTS ON A ONE-TIME BASIS

Mr. **Stockman**. Let me respond quickly by saying we will pursue these suggestions you have made, but there is one thing that is important. We would like ideas from you and this committee as to how relief efforts, if those are to be done, could be handled on a one-time basis and not simply by increasing programs that we have reformed and got under control. If you take that same forecast that I have been citing, and we do the things that are necessary to even have a moderate recovery, unemployment will come down steadily every year and we will have more jobs. The kinds of conditions that you are talking about will evaporate for the most part.

So if we are going to do anything in the short run to respond to it, let us make sure it is a shortrun solution, and not a long-term program that will not solve anything.

Senator **Riegle**. You can do this today. You can call the people that run the Capuchin Fathers Soup Kitchen in Detroit, one of the biggest soup kitchens, and they are one of the best known in the country. They can tell you over the telephone this afternoon the dimension of the emergency they are now struggling to cope with. They do not have the money. They do not have the resources. There needs to be a response.

I agree, let us not set up a whole vast bureaucracy, but it only takes an effort to talk to the people that are dealing with it. What is needed is food, clothing, medical care, and shelter. Those are the items and we have to be willing to pay for them. That means they ought to be in this budget. It does not have to be fancy but it has to meet those needs and I urge you to try to focus on it. It is desperately needed.

Chairman **Domenici**. Your time is up.

Senator Sasser.

STRUCTURAL DEFICITS

Senator **Sasser**. David, this morning there was a column in the Washington Post written by a distinguished national journalist, and I am sure you have read it, "The Missing Trillion Dollars," and it talks about the operations of your office, and says, and I quote, "Tax cut that the President cheered through Congress in the summer of 1981 has reduced revenues as projected under current economic assumptions by more than $1 trillion over 1984 through 1988," and the quote the columnist uses comes from a publication that comes from your office. And the column goes on to be critical of the tax cut of 1981.

Now, you said a moment ago, and I believed you, you said that there is nothing that we can do that will be drastic and right that is going to solve the problem that we have with the present budget. I have seen recent estimates, specifically by the House Budget Committee, which put out an excellent document on the budget, that the structural deficit under the current economic policies pursued by this administration are going to total $1.3 trillion between now and 1988; that as we all know here, more than double the national debt.

Now, you say we cannot go back and undo the 1981 tax cut that cost us a trillion dollars. You indicate that you know of no way we can make significant cuts in the deficit without impairing the national defense effort. What do we do about these massive structural deficits? They are going to absorb all of the projected private savings of this country. I am looking at some figures here that indicate that the deficit projected in 1983, and this is put out by the House Budget Committee, will absorb 135 percent of the private savings of this country.

Now, I was over at the White House when you and the Secretary of Treasury and Mr. Feldstein were giving us an overview of the budget, brief overview of the economy, and the concern expressed then, by I thought the Secretary of the Treasury and yourself, and I do not want to read more into what you were saying than what you said, concern about what is going to happen if interest rates go back up.

Well, my question is twofold. What are you going to do about the structural deficits, and if you do not do something about them, are you not—is it going to follow, just as night follows day, that either interest rates are going to go back up or you will have to turn on the printing presses again?

CURE COVERS VARIETY OF AREAS

Mr. STOCKMAN. I think that is what I have been saying. The rest of this book that you were referring to explains what we propose to do about it. It will be difficult, and it covers a whole variety of areas. You may argue about the mix, you may argue about the proportions; I assume that is what the Democratic process is all about. What I was trying to say is there are no miracle cures. You cannot do it by taking 25 percent of GNP in taxes or dismantling the Defense Department. There are a lot entitlements and domestic programs, but you cannot do it all there and you cannot do it by assuming 6 percent growth for 6 years. So you have to have a little bit of all of the elements put into a package that is consistent with a basic objective that we have in this country of slowing the growth of Government, keeping the tax burden down, and having a secure national defense. We think this package reflects that mix, but I can tell from conversations that others will put more in column A and less in column B.

But let us debate it and weight it and look at the choices and then get something done.

Senator SASSER. What is Mr. Volcker saying about the structural deficit? It appears to me he has been saying unless something is done about it, interest rates will turn around and go back up. Then we hear the Secretary of the Treasury saying, well, we hope interest rates do not go back up because if they do, this will kill off any hope of recovery. It is as if the Chairman of the Federal Reserve Board and this administration just sail back and forth shouting messages as they go by, but nothing occurs.

BASELINE DEFICIT REDUCTION

Mr. STOCKMAN. The budget has $558 billion of honest, goodness reduction in that baseline deficit. If you achieved that you would have dismantled a major part of the permanent imbalance. You would have diminished the structural deficit enormously. You would have given the financial markets, the Federal Reserve and the economy generally a decent chance to move forward, to get this economy recovering, and people back to work.

But if you do not do that—either with this mix or one that you think is better and still consistent with the objectives I have laid out—then you can be sure that the structural deficit is going to cause enormous damage and enormous suffering everywhere.

Senator SASSER. My time is up. Mr. Chairman, thank you.

Chairman DOMENICI. Thank you.

Senator BIDEN.

STRUCTURAL DEFICIT OF $100 BILLION WITH ROBUST RECOVERY

Senator BIDEN. Mr. Stockman, what does structural deficit mean?

Mr. STOCKMAN. Well, I think that has not been defined by anyone formally. It is that part of the deficit that is not attributable to shortrun cyclical deficits. In the oldfashioned definition, the deficit you would have at full employment, more or less.

Senator BIDEN. So that when we talk about the structural deficit in the context of this discussion, budget, and the process, the give and take you refer to, that means that even if we have a robust economic recovery, not just the moderate recovery that you are predicting, but a robust recovery, that we will still have a deficit that is in the—a structural deficit that is in the area of $100 billion, is that right?

Mr. STOCKMAN. Yes. We have a chart in the back that amplifies that point, on page 45 of my prepared statement.[1] Even if we had 1 percentage point higher growth every year between now and 1988, which would be 5 percent of growth for 6 years, well in excess of anything that has normally happened historically, we would still have a $232 billion deficit in 1988 under current policy without doing all the things proposed in this budget.

Senator BIDEN. You are probably the wrong guy to make this next statement to because although I believe Senator Johnston meant what he said in his opening round I think you were the one that this administration should have listened to the first time around. Obviously you cannot comment. And I might add, listened to the chairman of this committee—that is not an endorsement for your reelection, Mr. Chairman.

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[1] See p. 78.

Chairman **Domenici**. We will use it anyway.

ANALYSIS OF SUPPLY-SIDE HELP TO BALANCE BUDGET

Senator **Biden**. But if they had listened to both of you, we would not be here.

Here is the question. What you, you in an editorial sense—what the administration seems to be saying as they discuss structural deficits is that the supply side never, no matter how well it works, will be able to get to that, because no matter how well the supply side works, which was the idea of a robust recovery and reinvestment and so forth, that was not going to get us to that balanced budget anyway. Is that a fair analysis?

Mr. **Stockman**. No, I do not think that is a complete or fair analysis. Some things happened that you did not foresee and we did not foresee and the best experts did not foresee in February 1981. One was that we had to go through 2 years of extreme dislocation and interruption in financial and business activities in this country in order to purge inflation. We assumed at the time that that would happen very gradually and very slowly and there would be no loss of real GNP. The fact is that real GNP by the fourth quarter of this year, even with a good recovery, will be no higher than it was in January 1981. That is permanently lost.

BALANCED BUDGET AMENDMENT

Senator **Biden**. I promise you as long as this budget process is goinq on, I will try to, as best I can, equally assess blame and I indicated in my opening comments that I think we Democrats do not have a single answer for it. We do not know the exact way out, and the last guy was a part of the problem. But I would like, and I am not being facetious—I think it is important in order to get the record straight, you probably said it, but I would like a direct answer. The constitutional amendment to balance the budget is, I would assume, from your perspective at this juncture, an irrational proposal. I am not being facetious.

Mr. **Stockman**. I disagree with that.

Senator **Biden**. You think it is a rational proposal?

Mr. **Stockman**. I think a balanced budget amendment is a good idea as an anchor for national policy in the long run because it is fairly apparent from the experience of the 1970's and the experience now that we can find lots of ways to rationalize deficits. We need some kind of discipline to discourage that.

Senator **Biden**. Do you think that any Senator or Congressman who proposed the implementation of a balanced budget amendment to the Constitution of the United States of America that would take place any time, go into effect before the year 1990, would be acting rationally?

Mr. **Stockman**. On that point, I would say things are now so out of kilter that it will take 5 years of nontraditional solutions, of balanced mixes from all parts of this equation in order to get the budget back in equilibrium. After that, it would be appropriate to try to avoid the circumstances.

Senator **Biden**. I am not promising gains. But you will get from my Democratic friends that we need a quick fix and you and I both know that there is no quick fix. But I am an opponent of Roth-Kemp—in my State we call it Roth-Kemp—and the fact of the matter is I am not necessarily proposing to go back and repeal Roth-Kemp. It could be disastrous. We are so far down the well now it is like a decompression chamber, to pull up the victim quickly will cause the bends and you will have the worst case of economic disaster that we have on our records.

But I think it is important to pass on that, that we hope the demagoguery stops about balancing budget amendments and fiscally right the ship and do it immediately because you will not get much cooperation from us.

I see my time is up. If we have a next round, I would like to discuss with you the big ad, bipartisan ad that is being put out. It seems to me to be saying, as they say in the southern part of the State, "You all ain't doing enough." I know that the chairman of the board of Du Pont, who marched out of the front door of the White House the first time the President announced his budget, endorsing it in total, is a signator to this proposal. That did not come easy so I sure expect he feels it. But on the next round I will discuss those, or maybe another day.

DEFICITS NOT TOO LARGE FOR ECONOMIC RECOVERY

Chairman **Domenici**. I do not know if there is going to be another round.

From what I can see here, Mr. Stockman, the problem we are going to have, with reference to this 5-year plan, is how to deliver to this committee some assurance that a game plan—whether the standby tax is enacted for real, in advance, or whether it is a standby, with the taxes that are proposed, and the cuts that are proposed—how do we convince this committee that the deficits are not too large for economic recovery to really occur?

Now, I was an advocate, I do not know from whence the standby came, but I was an advocate of a very simple proposition that any 5-year budget plan that carried built-in deficits in excess of $200 billion with good recovery was self-defeating, that it would abort itself. To hang that kind of projected real deficit around the neck of the economy, and to say it is something that you are going to live with, will not work.

I assume from those kinds of discussions came the notion that if we get out there and the deficit is still that big, then let us add some taxes on. This action would send a dramatic signal that you would not be satisfied with those future year deficits, structural, or whatever. The deficits will be much smaller. But we are tying it at $208 billion, and we do not come down much, and then we come to $117 billion, if we have new taxes.

How is this committee going to gain confidence that that will work?

Mr. **Stockman**. Well, Mr. Chairman, I think only by working through all of the alternatives, if I might say that, since we have gone through 3 months of that up to this point. We recognize that it will be very difficult to find measures that can pass this Congress, that can get into law, and that can change the path of the budget to reduce the course of borrowing.

I have said many times, in private conversations, that I would rather have a 6-month COLA freeze that everyone agrees to, including the leadership of the other House, and the chairman of the Rules Committee, than a 2-year freeze that looks good on paper, but will never get done.

I think ultimately that is what you will have to balance. If you can come to the conclusion that you are cutting those deficits in real substantial ways from 6 to 2 percent of GNP—and not on paper, but in a way that can get the votes—then I think you can sell it to the rest of the Senate and the Congress.

REACHING FAVORABLE ECONOMIC CLIMATE LACKS CREDIBILITY

Chairman DOMENICI. Let me put it my way, Mr. Stockman.

I have concluded that if we were at a $5 trillion economy in 1988, which is what is projected, and the deficit of the United States is $100 billion, I believe that would be a very favorable economic climate.

The problem we are going to have, and the administration is going to have, is that there is going to be a lack of credibility that you can get to the $5 trillion and the $100 billion with $208, $187, and $190 billion and whatever the other number that comes down is. I do not have all of them memorized, and it is in that area that we must get some advice. I assume it would be those people in the marketplace that would take the risks, or not that the risks in lending money, and getting the real interest rates down to historic levels, instead of where they are now. Their advice, along with Paul Volcker's, would give some insight.

Mr. STOCKMAN. I would agree.

Chairman DOMENICI. We hope to get them here, and ask them that, but I would suggest to you, that is the crux of it. We have people that want the deficit down to zero by 1988. We will have some that do not see any way to get it down to $188 billion, when they put the package together. If this is a middle way, with the appropriate mix, certainly the Appropriations Committee will have broad discretion as to which they cut and which they add—obviously, there will be a decision on defense.

When all that is finished, you will still not be better than $100 to $117 billion, 5 years out, and we must convince enough people that that is a good economic plan. Yours is pragmatic, plus you think it would be such a gigantic relief to not have a $500 billion deficit, such a relief that you feel it is positive, if I read you correctly.

Senator Exon.

BIPARTISAN PLAN FOR CUTTING DEFICIT

Senator EXON. Mr. Stockman, I first want to congratulate you and the administration for the forthright approach to the budget.

Before you get carried away with that, I would add that it is the first forthright approach to the budget that we have had from the administration, and I would predict in the end the total numbers of the budget will be somewhere in line with what we accept. There will be some change in the mix, and I simply renew the statement that I made earlier in my opening comment, that I hope we can indeed go on a bipartisan approach.

In that regard, a group of rather distinguished Americans, a bipartisan group of several former Secretaries of the Treasury, and a former Secretary of Commerce, sounding the alarm that has been expressed on both sides of the table, and sounding of the alarm that you have also sounded, that they have proposed a plan that calls for cutting the deficit by 1985, by more cutting in defense nondefense areas, and by raising additional revenue to make up whatever difference is necessary.

Could you give us your thoughts on the reasonableness of that plan? I am sure you looked at it. What do you know of it?

Mr. STOCKMAN. Well, obviously, the concern that they have about the deficit is the one that you expressed, and we share. I am not convinced it is very practical. After hearing the comments this morning, I do not believe this Congress would adopt $60 billion worth of cuts in domestic programs for 1984 relative to the baseline. That is more than what we have proposed, and what we have proposed has been attacked rather broadly here this morning, at least in some of the specifics.

If I remember right, they are calling for $85 billion in taxes. That would be a massive surcharge, which is about the only thing that you could get into place quickly to generate that much revenue, and I doubt whether it would be helpful to sustaining the recovery.

So if you look at just those two elements, it all adds up to a very nice package of a $70 billion deficit, but I am skeptical whether those proposals are good policy and can get done.

Senator EXON. Let me ask you a followup question.

Assume, in your wildest imagination, that the Congress would enact the cuts in nondefense spending. Would the administration and the President, in your opinion, agree to make the cuts in the defense expenditures that they have indicated are necessary?

Mr. STOCKMAN. Well, they have indicated $25 billion in outlays in 1985, and that would have rather Draconian, and I use the word advisedly, and seriously disruptive effects on the basic elements of our national security policy which everybody agrees with, to say nothing of some of those that we are arguing about.

Chairman DOMENICI. Would the Senator yield?

Did you say by 1985, or——

Mr. STOCKMAN. In fiscal year 1985 they said they wanted $25 billion in outlay cuts. That is pretty hard to get that fast.

Chairman DOMENICI. Thank you.

Senator EXON. We can conclude at least that bipartisan approach to resolving the problem is rejected.

Mr. STOCKMAN. Well, it is a matter of degree. The degree of their numbers are not right.

PRESIDENT'S PROPOSALS SHOW DECREASE IN AGRICULTURE BUDGET

Senator EXON. I do not think you have been asked about the agriculture budget, and I anticipate that you would expect I would be asking about that.

The President's budget proposals show a dramatic decrease in the agricultural budget, as compared to last year. In round figures, $9 billion—minus 43 percent—second only of the items listed on table 2 on page 5 of an analysis prepared by the Committee staff entitled, "A Review of the President's Budget for Fiscal Year 1984."

Now, I would simply point out, that as I understand the budget recommendations, you would freeze target prices for 1984 and 1985 at the current levels, and not allow those to creep on up. There would be no paid diversion program in the 1984 budget year. There would be a 38-percent cut in the commodity credit export credit. At the same time I would say, on the other hand, the President is recommending a 25-percent increase in the Export-Import Bank.

It seems to me what you are really saying here is that the PIK program is going to be so outstandingly successful that we can emasculate the programs for agriculture. It seems to me, and I would like to have you respond to whether or not the cuts in the percentages that I just enunciated are essentially correct.

Mr. **Stockman**. Yes, but let me underscore that almost all of that reduction is due to the decline in CCC outlays without the freeze and even without the PIK program. In other words, if we left the current farm program in place, we are projecting enough improvement that outlays will decline from $19 billion, just a stratospheric point, a historical record in 1983, to $12 billion in 1984, and that accounts for almost all of that change. Beyond that, we think the target price freeze and PIK would save another $3 billion in 1984, but the decline is entirely in the CCC, and most is due to the automatic effect of current law and the changed projections for farm markets.

MAKE AMERICAN FARMER COMPETITIVE WITH HIS COMPETITORS

Senator **Exon**. Mr. Stockman, you may be right, but I think in this case you are wrong, and I think at least this part of the budget recommendations should be exempted from what I said a few moments ago about being realistic for this reason.

I am fearful that the PIK program, while designed for some short-term benefits, to the very, very hard pressed American farmer, is merely transferring the problems of the American Government back to the farmer. If the PIK program is as good as you think it will be, then likewise we would offer the same kind of a program to our dairy farmers, and pile up all of that cheese and butter that we have back on their farms, for them to dispose of.

Now, it seems to me that what you are overlooking here is that you may be crippling the chances for the PIK program to work by withdrawing some of the support for export credit on these crops that are so vitally necessary.

I would hope that you would take another look at that, because just transferring the grain to a farmer is not going to solve the problem in the long run. He has to dispose of it, hopefully with some degree of profit over the long haul. The dramatic increase for the Export-Import Bank, which is not directly agriculture related, and the drastic reduction in the commodity credit export subsidies, I think are going to imperil, to a large degree, the chance of us selling this overseas, given the dramatic subsidy that is being granted by most of our competitors in selling the products of their farmers overseas.

Mr. **Stockman.** Well, I appreciate your point. I wish you would look at it a little harder. I am not sure what you are referring to, but probably the reduction in CCC credit, or loan guarantees for agriculture exports. I have to point out that the number in 1983 is artificially high because a few months ago, when Mexico was at the worst point of its crisis, we made a special increase in the ceiling and provided 1 billion dollars, I believe it was, for CCC exports to Mexico. But in terms of other than that, it is the same level as last year.

Senator **Exon.** Well, Mr. Stockman, I will say I will look at it further. I would hope that you will also. It may be something that has fallen through the cracks, and I think the administration has at least said in the past they wish to be helpful to our exports—our farm products that we have in great surplus, and simply make the American farmer competitive on a dollar-for-dollar basis with his competitors around the globe.

My time is up. I thank the Chairman.

Chairman **Domenici.** Mr. Stockman, I have some written questions I am going to submit to you.[1]

Would you submit for the record, at your earliest convenience, the following information: Take the 5-year President Carter defense budget and put it out on a 5-year projection, telling us in each instance what the inflation rate assumption was, and if there was a realistic difference between the inflation rate used there, GNP deflator, and inflation assumed in the economy.

If there is none, then give us the straight numbers, and take the President's 5-year budget in its initial form, without the deductions that are now being talked about, put that into 5-year form, and then extend it out since it will go beyond Carter's, and tell us the percentage of inflation assumed in each instance, when it was first done, and tell us the trendline, and show us the percent inflation, or GNP deflator that is assumed there.

Would you do that for us?

Mr. **Stockman.** Yes.

Chairman **Domenici.** I appreciate that.

[The following was subsequently submitted for the record:]

Year	Carter budget (January 1981)		Reagan budget (February 1982)	
	GNP deflator (percent)	Defense composite deflator [1] (percent)	GNP deflator (percent)	Defense composite deflator [1] (percent)
1981	10.4	11.8	9.5	12.9
1982	9.7	9.4	8.2	8.7
1983	8.6	9.1	6.5	6.9
1984	8.0	8.0	5.1	5.9
1985	7.2	7.3	4.8	5.5
1986	6.4	6.6	4.6	5.1
1987			4.5	5.0

[1] Composed of pay (military, civilian, and retired) and purchases of goods and services.

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[1] See p. 113.

Senator **Exon**. Before you close, maintaining a bipartisan approach and spirit that we are in today, if you are going to do that at the Chairman's request, could you likewise supply the budget figures that President Nixon and President Ford had, likewise, so we could compare the whole?

Mr. **Stockman**. I could go back to Herbert Hoover, if you like.

[The following was subsequently submitted for the record:]

NATIONAL DEFENSE OUTLAYS

[In billions of dollars]

Fiscal year	Current prices	Constant (fiscal year 1972) prices
1970 (Nixon)	78.6	90.1
1971 (Nixon)	75.8	81.4
1972 (Nixon)	76.6	76.6
1973 (Nixon)	74.5	70.0
1974 (Nixon)	77.8	68.4
1975 (Ford)	85.6	68.7
1976 (Ford)	89.4	67.1
1977 (Ford)	97.5	67.8
1978 (Carter)	105.2	68.0
1979 (Carter)	117.7	70.6
1980 (Carter)	135.9	72.7
1981 (Carter)	159.8	76.4
1982 (Reagan)	187.4	81.7
1983 [1] (Reagan)	214.8	88.8
1984 [1] (Reagan)	245.3	97.7
1985 [1] (Reagan)	285.3	107.7
1986 [1] (Reagan)	323.0	116.1

[1] Estimate.

Chairman **Domenici**. I am only looking for the inflation rate at this point. That is really what I would like to know.

[Whereupon, at 1:10 p.m., the committee adjourned, subject to the call of the Chair.]

WRITTEN COMMITTEE QUESTIONS TO MR. STOCKMAN AND THE RESPONSES

EMPLOYMENT

Mr. Stockman, I note that the budget proposes a nearly tenfold increase for Title III of the Job Training Partnership Act (JPTA), the new program for training and assistance to dislocated workers, as well as several other initiatives.

QUESTION 1:

Will the administration negotiate with Congress on a stronger jobs program package to respond to the effects of this rescession on workers?

ANSWER:

The President has made clear his opposition to make work proposals. Such programs have a long history of failure, and they do not justify the expenditure of public funds. Public service employment is such a make work program.

The Administration has said that it would consider shifting into fiscal year 1983 funds requested for fiscal year 1984 for Federal agency construction and repair activities so that the employment-generating effect of these activities can be accelerated. The employment generated by these activities would be predominantly in the private sector. No final decision has been reached, however, with regard to the specifics of ssuch an initiative.

EMPLOYMENT

Question 2: You propose converting unemployment benefits to wage subsidies. Have you considered the possibility of allowing unemployment benefits to pay for job training as well?

Answer: We agree that States should be given the flexibility to use a reasonable portion of amounts they raise to pay unemployment benefits for programs to help the unemployed get jobs. We are proposing that States be permitted to use up to 2% of their State Unemployment Insurance tax receipts for training, job search and relocation of unemployed workers. The decision on whether to do so would be left to the States.

Unemployment benefits currently paid to claimants are available for their use as they see fit. Under current law claimants can use part of their regular unemployment benefits to undertake training that has been approved by the State agency.

UNEMPLOYMENT COMPENSATION AND STATE TRUST FUNDS

The administration's budget includes a proposal to extend for six months the program of long-term benefits for the unemployed.

Question 1: Would you describe the program for the Committee?

Answer: The Administration proposes extending the duration of the temporary Federal Supplemental Compensation (FSC) program through the end of fiscal year 1983. This program, which went into effect in September 1982, is scheduled to expire on March 31, 1983.

Federal Supplemental Compensation is available to those who have exhausted their regular and extended unemployment benefits. In contrast to other unemployment compensation programs, it is funded from federal general revenues and thus is not a financial burden on either employers' payroll taxes or the states.

Depending on the unemployment rate in a particular state, FSC pays standard benefit amounts for varying lengths of time -- the higher the state insured unemployment rate, the longer the benefit period. Under the Administration's proposal, recipients in states with unemployment rates of 6 percent or above would be eligible for up to 16 weeks of additional benefits; those from states with unemployment rates between 4.5 percent and 6 percent would be eligible for up to 12 weeks of additional benefits; those from states with unemployment rates below 4.5 percent would be eligible for up to 8 weeks of additional benefits.

In an effort to improve the targeting of FSC to those individuals who have suffered unemployment through no fault of their own and who have had a relatively permanent attachment to the labor force before becoming unemployed, the Administration proposes to limit FSC benefits to those who have had at least 30 weeks of employment during the year preceding their unemployment and became unemployed for reasons other than voluntarily quitting their jobs or being fired for good cause.

The six-month extension of FSC will cost an estimated $1.85 billion. The extension will provide needed assistance to 1.3 million long-term unemployed.

We also propose supplementing the extension of FSC with a new job voucher program to help the long-term unemployed in obtaining productive jobs. Under current law, no special tax incentives are provided to employers who hire individuals after they have experienced a long term of unemployment.

Under our proposal, individuals who are eligible for FSC benefits will have the option of converting their payments to vouchers. These vouchers will entitle an employer hiring the individual to receive a tax credit equivalent to the value of the voucher. The value of an individual's weekly voucher will equal one-half of the individual's weekly FSC benefit. An individual will be eligible for twice as many weekly vouchers as weeks of additional unemployment benefits.

When the extended FSC program expires at the end of the current fiscal year, job vouchers will be offered to the long-term unemployed who otherwise would have been eligible for FSC benefits using the same eligibility criteria.

Private employers will receive the tax credit if they hire quialified individuals for full-time employment. Qualified individuals include those who meet the eligibility requirements for FSC benefits. An employer will not be allowed to claim the subsidy for rehiring a former employee.

Employers can apply the voucher as a credit against state and federal unemployment insurance taxes. If the employer has more than enough vouchers to satisfy those tax liabilities, the remaining vouchers can be applied against federal income taxes. This will provide an incentive to virtually all private sector employers, including nonprofit institutions, to hire the long-term unemployed. The program will not affect state unemployment insurance trust funds since tax credits claimed will be reimbursed to the trust funds from general revenues. The tax credit is not refundable. Employers must reduce the deduction for wages and salaries by the amount of the credit earned. Employers with insufficient tax liabilities to use the credit in the current year can carry the credit forward against Federal income and unemployment tax liabilities for 15 years, and back for three years against federal income tax liability.

Individuals must use the vouchers within a year of the time they become eligible. Individuals must begin using the vouchers before April 1, 1984. The job voucher program will benefit an estimated 200,000 individuals during FY 1983 and 500,000 during FY 1984.

UNEMPLOYMENT COMPENSATION AND STATE TRUST FUNDS

Question 2: Will there be any changes in which individuals get benefits, or how many weeks of benefits are provided in each state?

Answer: I have described the changes in eligibility, and the number of weeks of FSC that would be available in my response to question 1, above.

Question 3: Are you proposing any legislation to restore solvency to the State unemployment funds? Any special plans for States with large debts?

Answer: Legislation was enacted in 1981 and 1982 to encourage States to restore solvency to their unemployment funds. That legislation is beginning to work. Significant changes in State unemployment insurance laws have been enacted in Michigan and Louisiana. Other States are actively considering major changes to their laws. The States, in making these changes, are responding to the 1981-82 changes in Federal law, which require that interest be paid on new loans made to States from the Unemployment Trust Fund beginning April 1, 1982. States experiencing particularly high unemployment are permitted to defer three quarters of their interest payment for a given year, which is repaid, with interest, over the next three years. States which need money only to resolve short-term "cash flow" problems are not charged interest on those loans. Federal law at the same time was changed to permit States that are taking satisfactory steps to restore solvency to their unemployment funds to stretch out the repayment of their past-due loans.

We believe that further legislation in this area is neither necessary nor desirable. The interest charges on new loans made beginning April 1 have provided the necessary incentive for State action. Federal law takes into account difficulties faced by States with particularly high unemployment by permitting them to defer three quarters of the current year's interest payment. In addition, States which demonstrate their resolve by taking sufficient action to restore solvency to their unemployment fund benefit from a "cap" on the Federal tax used to recoup unpaid past due loans. This stretches out the repayment period of loans, most of which provide a Federal subsidy to the borrowing State, since they are interest-free.

These provisions apply to States with large and small debts alike. They represent an equitable way to deal with the underfinancing of State unemployment benefits. Any further attempt at this time, when the economic recovery has begun, to postpone payments of loans or interest would have extremely unfortunate consequences. When such steps were taken in 1975 and 1977 after an economic recovery was underway, States treated the postponements as an encouragement not to take actions to restore their unemployment funds to solvency during the period when they were best able to do so. As a result, many States were completely unprepared for the 1981-1982 increase in unemployment.

Action to bring the State unemployment funds into balance and keep them there is properly a matter for State legislatures, not the Federal Government.

HOUSING -- GENERAL

Question 1: How important is lowering inflation to making housing more affordable?

Answer: Because long-term financing is required for most home purchases, lowering mortgage interest rates is probably the single most important action that can be taken to make housing more affordable. And because the level of mortgage interest rates is to a large extent a function of lenders' expectations of future inflation, lowering inflation may be the single most important action that can be taken to lower mortgage interest rates and thus make housing more affordable.

One of the top priorities of this Administration is to keep inflation under control. Just two years ago, prices were increasing at annual rates exceeding 12%. As a result of the President's comprehensive Economic Recovery Program--which includes controls on Federal spending, a consistent monetary policy, and efforts to reduce costly regulations--prices in 1982 increased at an annual rate of only 3.9%. Mortgage interest rates have followed the decline in inflation rates; the maximum FHA rate fell from 17.5% in 1981 to 12% today. More than 6 million families are eligible for a 30-year, $60,000 mortgage at 12% than were eligible at 17.5%. On a $60,000 mortgage, monthly payments are reduced from $879.80 at 17.5% to $617.17 at 12% -- a savings of $94,520 over a 30-year term.

This increased affordability has been achieved without a bailout, without special subsidies, without major new budget-busting initiatives that would have only added to the deficit, exacerbated the underlying inflation rate, provided a rapid return to high interest rates, and further weakened the housing industry and the economy. Instead, the success of the President's program of lowering inflation has made housing much more affordable.

HOUSING -- GENERAL

Question 2: What is the Administration's view of the appropriate federal role in the secondary mortgage market?

Answer: To ensure that the private sector has the opportunity to enter the secondary mortgage market, the Administration is considering a package of regulatory and tax changes that will eliminate unnecessary barriers to the issuance of private mortgage-backed securities. Known as TIM's (trusts for investments in mortgages), the resulting instruments will make the secondary mortgage market more accessible to private institutions. This improved competition should allow the entire secondary mortgage market to keep pace in the increasingly deregulated financial environment.

The Administration also remains committed to seeking the total privatization of two of the housing related Government-sponsored enterprises, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation. Because of their Federal Government sponsorship, these enterprises receive special advantages in the securities markets that completely private institutions do not have. An interagency Cabinet-level group will continue to pursue the goal of complete privatization of these enterprises.

Until these changes can be implemented, the budget proposes new commitments levels for the Government National Mortgage Association's Mortgage-Backed Securities program of $68.25 billion for 1983 and $58.64 billion for 1984. The guarantee levels of $35.24 billion and $39.1 billion are based on FHA and VA estimates of mortgage insurance and guarantee activity in 1983 and 1984, respectively. A new commitment fee structure is being introduced in 1983. This fee schedule is a sliding scale based on the amount of commitment requested. Thus, it is expected to reduce the amount of commitments issued without adversely affecting the level of guarantees issued.

HOUSING -- GENERAL

Question 3: Would the Administration consider slowing or delaying the deregulation of depository institutions as a means of addressing these issues?

Answer: Deregulation of depository and, in particular, thrift institutions is critically important for redeveloping a healthy thrift industry and thus a healthy source for housing financing. As you are well aware, thrift institutions, which are the nation's largest mortgage lenders having originated about 50% of all mortgages in 1982, have encountered severe financial problems in recent years as a result of high inflation and high, volatile interest rate levels. The removal of asset and liability restrictions on these institutions, as embodied in the Garn-St. Germain Depository Institutions Act of 1982, will enable them to compete with other financial institutions and financial service companies.

It would not be possible for the thrift industry to continue to be major financiers of housing if it remained encumbered and restricted by past regulations. Furthermore, the Administration believes that there is little danger that the thrift industry will abandon, or even significantly lessen, its activity in mortgage finance primarily because of their expertise in the area. Also, until the tax code is changed, these institutions have another incentive to continue to originate mortgages. In addition to new and broader lending powers, variable rate mortgage instrument innovations should enable thrift institutions to enhance their profitability, and thus increase the availability of funds for housing, because their assets and liabilities will be better matched.

In sum, slowing or delaying the deregulation of these institutions may well be extremely harmful to the housing industry.

AGRICULTURAL PRICE SUPPORT EXPENDITURES

Question: The President's budget includes estimates for farm price support programs that, even after assumed legislative changes and a reduced current services base, still are very high by historical standards. For fiscal years 1977 through 1981, farm price support outlays averaged $3.9 billion; for fiscal years 1982 through 1987, estimated outlays would average $12.1 billion. What do these historically high, long-term outlay estimates indicate about the state of our changing agricultural economy, but more importantly about how current Federal farm programs function within that changing environment?

Answer: The recent increases in Commodity Credit Corporation (CCC) outlays are largely results of supply/demand imbalances for agricultural goods. Over the past two years, good weather conditions and high U.S. price support levels have resulted in unexpected increases in farm crop production, both in the U.S. and other countries. This increased supply, coupled with lower world demand than anticipated, has reduced prices and created large surpluses of farm goods. As the current farm programs automatically cushion the adverse effects of low prices and excess supplies, CCC outlays have grown to record levels.

Unless current Federal farm programs are changed to better adapt to these new world market conditions, CCC outlays will probably remain high, farm prices will probably remain low and agricultural surpluses will probably continue to grow. The President's farm program should begin to correct the current supply/demand imbalance, improve farm commodity markets and reduce Federal budget outlays. A combination of payment-in-kind (PIK) and a freeze in target prices should produce a substantial reduction in farm surpluses. The Administration remains convinced that the best farm programs are those which allow maximum flexibility, thereby providing the ability to respond quickly to changes in the agricultural economic environment.

Question: Would you please discuss the basis for your proposal to freeze target prices at their current levels? Of the $3.1 billion assumed outlay savings in FY 1984, and $28.8 billion over the next five years, how much is due to the freeze on target prices and how much is due to the announced PIK program?

Answer: The target prices mandated by the Agriculture and Food Act of 1981 were based on projections of costs of production which, due mostly to a decline in inflation and interest rates, are no longer valid.

- The 1981 projections of farm costs of production estimated a 27% increase for wheat and a 30% increase for corn, over the 1981-85 crop year period.
- Accordingly, the 1981 program for target prices built in a 22% increase for wheat and a 33% increase for corn, over the 1981-85 crop year period.
- However, currently projected farm costs of production are expected to increase by only 14% for wheat and 13% for corn, over the same period.

Unless changed now, these excessively high target prices will continue to provide an incentive for over production--maintaining large surpluses, low farm prices and high Government costs. A freeze of target prices would more than cover currently projected increases in farm production costs, reduce the incentive for over production, and provide substantial savings to the American taxpayer. This proposed freeze is consistent with other inflation-related program proposals, including a freeze in cost-of-living adjustments and freezes of many discretionary Federal programs Government-wide.

Outlay savings under the President's farm program can be divided as follows:

($ in Millions)

	1983	1984	1985	1986	1987	1988
PIK and other reforms	604	2,588	4,100	3,500	3,300	300
Target price freeze	--	550	1,900	3,300	4,300	5,000
Total savings	604	3,138	6,000	6,800	7,600	5,300

Question: Direct Government payments to farmers were about $2 billion in 1981 and are estimated to be about $4.0 billion in 1982. Therefore, about one-tenth in 1984 and one-fifth of net farm income in 1982 was attributable to direct Federal Government assistance. Given the projected large farm support outlays over the near term, what happens to this ratio? Does the proportion of projected net farm income attributable to direct Government assistance continue to rise or fall?

Answer: The Department of Agriculture has estimated that direct payments to farmers will be about $4 to 5 billion and net farm income will be about $17 to 21 billion in calendar year 1983. The calendar 1983 payment to income ratio is therefore projected to be slightly above one-fifth.

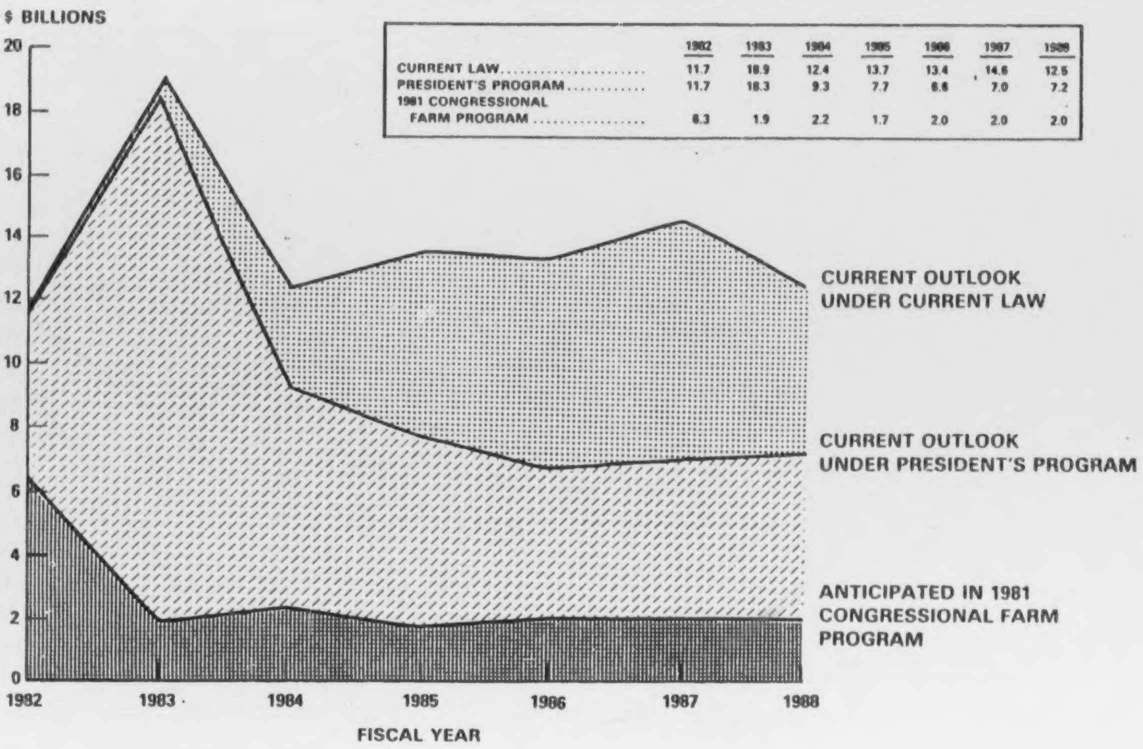
Under current law, we project that direct payments to farmers would grow to substantial levels: from $2.2 billion in (fiscal year) 1982, or 19% of total CCC outlays, to $9.3 billion in 1988, or 74% of total CCC outlays. Most likely, under current law, direct Government payments would gain an increasing share of farm income.

Under the President's program, we expect direct payments to decline significantly. Direct payment savings are estimated to be $2.7 billion in 1984 and growing to $6.0 billion of savings in 1988. Most likely, under the President's program the direct Government payments share of farm income would be reduced as farmers gain an increasing share of their income from the marketplace.

On the following pages are charts which provide additional information on the above price support issues. The charts are as follows:

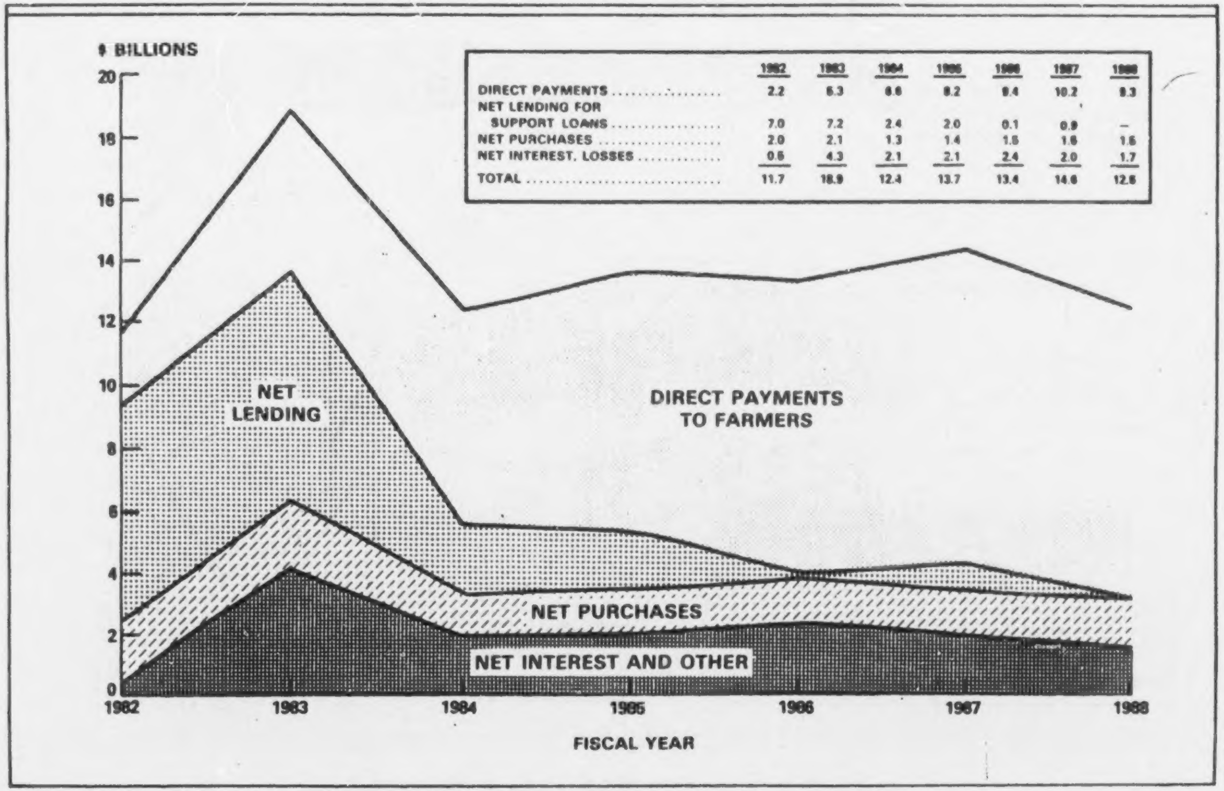
- o Farm Program Outlays - comparing the outlay levels projected in 1981 with the outlay levels currently projected under both current law and the President's program.
- o Farm Program Outlays Under Current Law - illustrating the breakdown of program outlays.
- o Grain Costs of Production Estimates - comparing costs of production for wheat and corn projected in 1981 with the current outlook.
- o A Freeze on Target Prices - illustrating the target price effect of the President's program.
- o Farm Program Outlay Savings - illustrating the breakdown of program savings.

FARM PROGRAM OUTLAYS



	1982	1983	1984	1985	1986	1987	1988
CURRENT LAW	11.7	18.9	12.4	13.7	13.4	14.6	12.5
PRESIDENT'S PROGRAM	11.7	18.3	9.3	7.7	6.6	7.0	7.2
1981 CONGRESSIONAL FARM PROGRAM	6.3	1.9	2.2	1.7	2.0	2.0	2.0

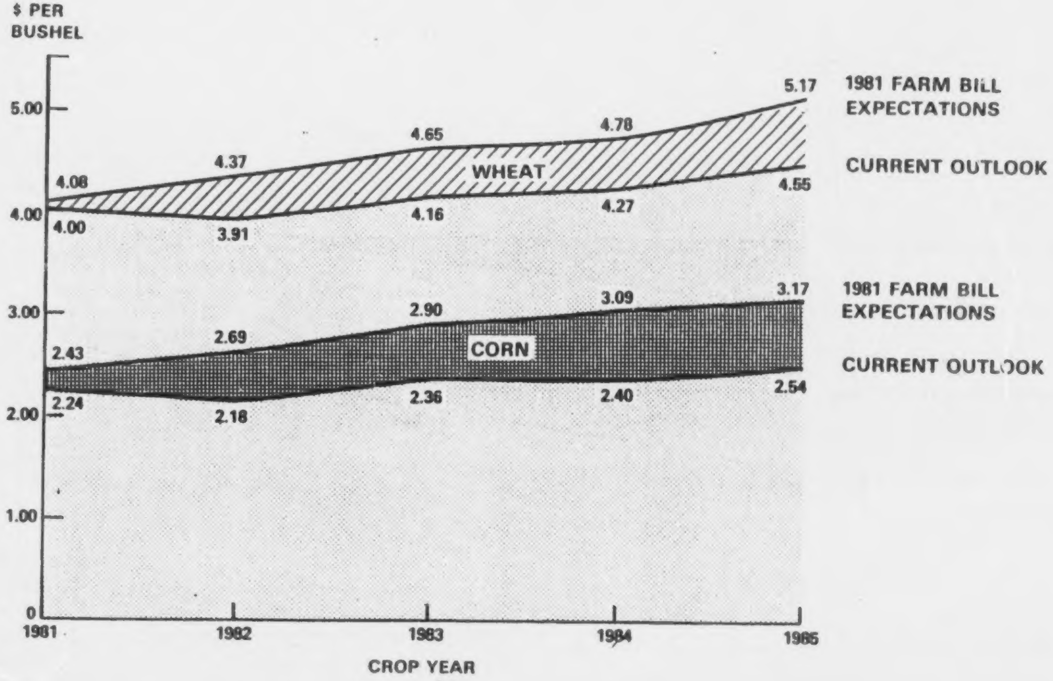
FARM PROGRAM OUTLAYS UNDER CURRENT LAW



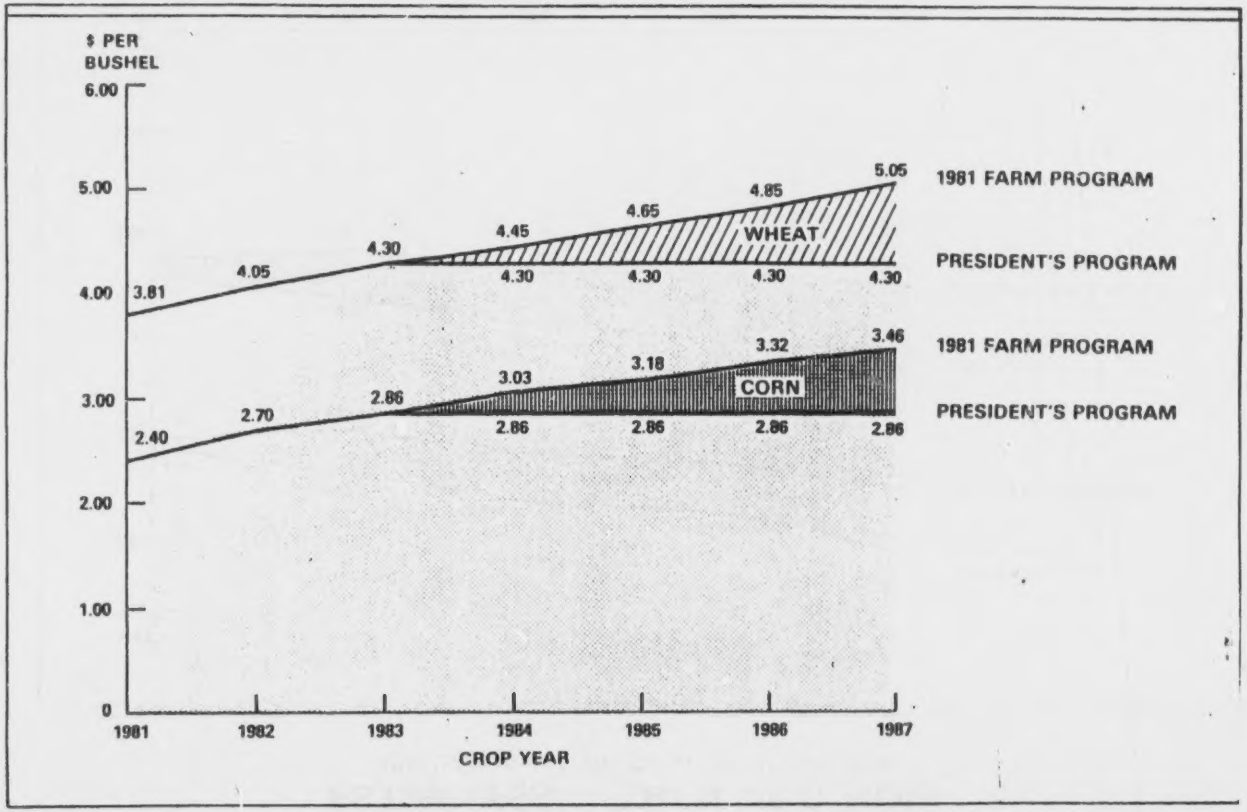
	1982	1983	1984	1985	1986	1987	1988
DIRECT PAYMENTS	2.2	5.3	6.6	8.2	9.4	10.2	9.3
NET LENDING FOR SUPPORT LOANS	7.0	7.2	2.4	2.0	0.1	0.9	–
NET PURCHASES	2.0	2.1	1.3	1.4	1.5	1.5	1.6
NET INTEREST, LOSSES	0.5	4.3	2.1	2.1	2.4	2.0	1.7
TOTAL	11.7	18.9	12.4	13.7	13.4	14.6	12.6

GRAIN COSTS OF PRODUCTION ESTIMATES — THEN AND NOW

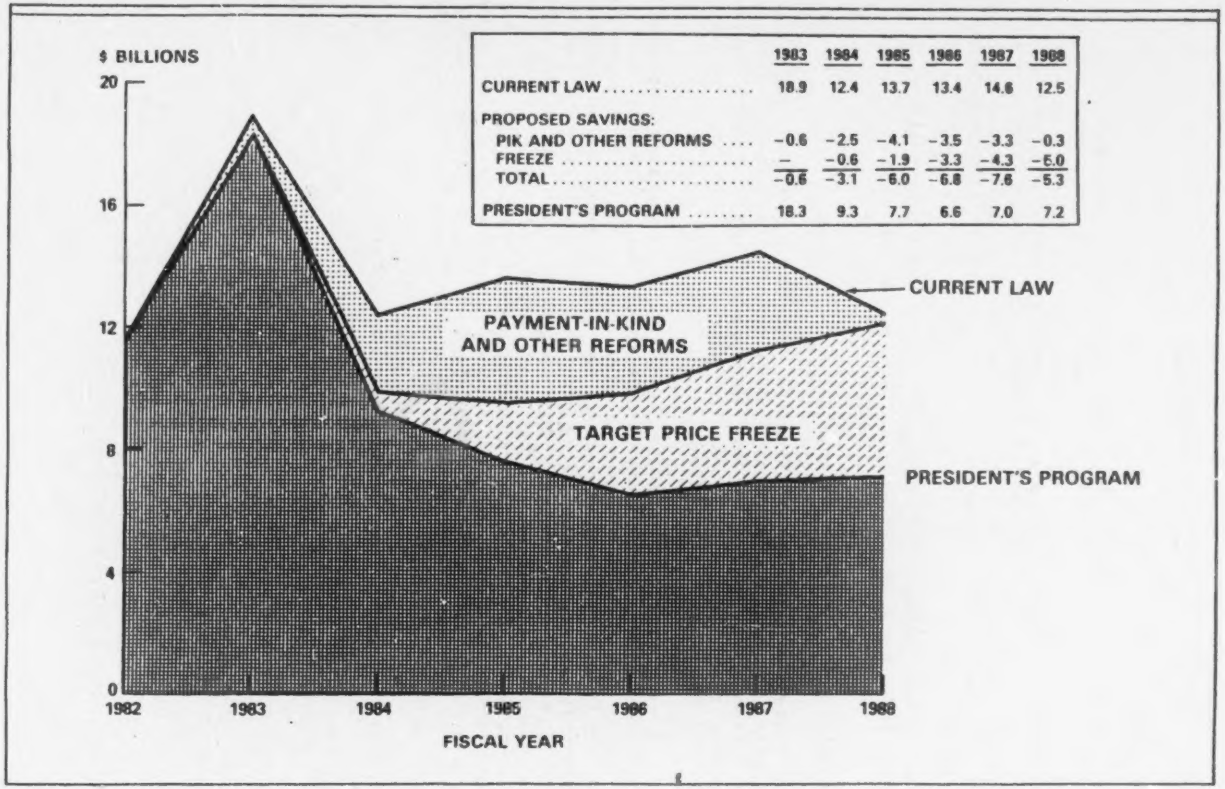
(TOTAL COSTS OF PRODUCTION, EXCLUDING LAND)



A FREEZE ON TARGET PRICES



FARM PROGRAM OUTLAY SAVINGS



	1983	1984	1985	1986	1987	1988
CURRENT LAW	18.9	12.4	13.7	13.4	14.6	12.5
PROPOSED SAVINGS:						
PIK AND OTHER REFORMS	−0.6	−2.5	−4.1	−3.5	−3.3	−0.3
FREEZE	—	−0.6	−1.9	−3.3	−4.3	−5.0
TOTAL	−0.6	−3.1	−6.0	−6.8	−7.6	−5.3
PRESIDENT'S PROGRAM	18.3	9.3	7.7	6.6	7.0	7.2

FEDERALISM

Question 1:

Mr. Stockman, many of the programs included in the administration's revised "New Federalism" plan have been targeted for cuts or elimination. For example, the WIN program and the low-income energy assistance program are included in the administration's consolidated federal-state block grant proposal. However, no funding is provided for the WIN program and funding for the low-income energy assistance program has been reduced by $500 million.

How do you expect the states to take over responsibility for these programs when adequate funding is not provided?

Answer

The State block grant, proposed as part of the revised federalism initiative, consolidates more than 20 health, social service, education, and community development programs. Annual funding for the block grant is set at the sum of the 1984 enacted levels for the consolidated programs.

Budget authority proposed for most of the separate programs in the 1984 budget, is unchanged from 1983. No budget authority is proposed for the WIN program in 1984 because it has not proven to be cost-effective. In addition, the administration has proposed mandatory work programs for appropriate AFDC recipients and the Job Training Partnership Act requires that eligible AFDC recipients be served on an equitable basis with others. Therefore, the need for a separate jobs program for AFDC recipients no longer exists. Proposed reductions in low income home energy assistance are the result of a new allotment formula that directs funds more precisely to low-income persons in States with severe winter climates.

In spite of these reductions, we believe that the overall funding level for the block grant is adequate, particularly in view of the increased flexibility associated with State administration of the block grant program. While States must use the block grant funds for the same general purposes served by the consolidated programs, 20% of the funds in 1984 could be spent on any program purpose within the block grant. This amount increases by 20% each year through 1988. At that time, States have complete discretion over how the funds are used, as long as they are within the general purposes of the block grant. This provision gives States the flexibility to establish their own funding priorities. They may increase funding for low income energy assistance or provide funds for job training programs for AFDC recipients if they so choose.

FEDERALISM

Question 2:

Doesn't this budget ignore the fact that 31 States are either in or on the verge of major deficits in their current fiscal years? How can State and local economies recover if they are forced to increase taxes and cut essential spending because of federal monetary and budget policies?

Answer:

Recent reports on State fiscal conditions, prepared by the National Conference on State Legislatures and by OMB staff, agree that the recession, rather than administration policy, is the major cause of current State fiscal problems. Because of the growing dependence of State and local governments on income sensitive taxes -- particularly the individual income tax -- the recession and reduced inflation have caused revenues to fall substantially below previously anticipated levels in some States. Self-imposed tax limitations have made it difficult for States to offset the resulting reductions with tax increases. These revenue shortfalls have been accompanied by an increased demand for welfare and unemployment related services.

As an aid to States and localities, Federal grants are proposed to increase from $88.2 billion in 1982 to $95.9 billion in 1984, a 9% increase over two years. The major increases are for payments to individuals, such as medicaid, as well as capital grants for highways and mass transit. However, the most important role the Federal government can play is to promote economic growth with low inflation. As the economy recovers, revenues from income sensitive taxes will rise and the demand for welfare and unemployment related services will fall, allowing States to build up their cash balances. The administration's tax and spending policies, proposed in the 1984 Budget, are designed to foster a strong, vigorous, and sustained economic recovery from the recession. These policies will have a positive impact on State and local economies.

MEANS-TESTED ENTITLEMENT PROGRAMS

21

Question:

The Administration is proposing many changes in means-tested programs that are essentially the same proposals submitted last year and rejected by Congress.

1. What has happened in the past year that makes these proposals worth considering again?

Answer:

The Administration has made a variety of legislative proposals in means-tested programs over the past two years. These proposals are all based on a careful evaluation of the problems which exist in current program rules and operating procedures, and a frank recognition that resources must be targeted on those who truly need them and cannot be self-sufficient, in order to curb program costs that have exploded beyond our means to finance them.

Congress has enacted a significant share of our proposals, through the Omnibus Budget Reconciliation of 1981, the Tax Equity and Fiscal Responsibility Act of 1982, and other legislation. Because of the large number of overdue changes we have proposed, it is not surprising that not all of them could be embraced immediately by the Congress. The legislative workload has been heavy and time has been short. However we continue to believe that our proposals are both necessary and desirable changes to return means-tested programs to a temporary safety net concept, and we anticipate that Congress will enact them.

We have also modified our proposals to remove possible problems and to encourage speedy enactment, for example:

- The Administration is again submitting an error rate reduction proposal for the food stamp program. We believe it is critical to reduce erroneous expenditures so that limited Federal funds can be focused on those who really need and deserve them. This year's proposal, however, has been revised to make the food stamp program consistent with the error rate requirements in other State-administered means-tested programs, such as Aid to Families with Dependent Children and Medicaid. Under this year's proposal, no Federal funds will be available for erroneous expenditures above 3% of a State's program costs. While our goal must continue to be elimination of all erroneous expenditures, we recognize the difficulty of reducing below a 3% rate. We further feel that error rate reduction goals and procedures should be as consistent as possible among the means-tested programs to facilitate effective implementation.

- The Administration is again seeking a comprehensive overhaul of the child support enforcement program to make it more successful and cost-effective in all States. Because of concerns about the potential effect of the financing arrangements in our restructuring proposal on cases that are not receiving AFDC, we have added a component which recognizes the welfare cost avoidance value of enforcing child support payments in non-AFDC cases and makes performance recognition payments to States for their efforts.

MEDICARE

Question:

Mr. Stockman, I think that you and I agree that Medicare growth is out of control. Medical care costs grew at over 11 percent last year, while the consumer price index was at 3.9 percent. Medicare is estimated to grow 16 percent between 1983 and 1984.

1. How will the Administration's proposals reduce the growth of the program?

Answer:

The Administration is proposing a comprehensive plan to reform the nation's health care financing system. These proposals will reduce the overall rate of health care cost inflation and benefit Medicare both directly and indirectly.

These reforms will eliminate structural defects in both the overall health financing system and in the Medicare program itself. The President's proposals include:

-- Medicare hospital reimbursement will be improved to eliminate cost-plus payments and to establish incentives for hospitals to provide care efficiently. Five year savings of $20 billion are anticipated.

-- A one-year freeze on Medicare physician reimbursement rates and eliminating hospital reimbursement in[illegible]ases over inflation will hold down the costs to [illegible]ents. This proposal will save $6 billion over [illegible] years.

-- Additional Medicare hospital cost sharing will increase cost consciousness on the part of physicians and patients for short hospital stays and will help pay for increased protection for the aged who must undergo long and catastrophically expensive hospital stays. Under the President's proposal, the cost to the patient of a six month extended illness would be reduced from $13,475 to $1,530. About 150,000 beneficiaries annually would be relieved of responsibility for hospital costs averaging over $9,000.

-- States would be required to impose modest copayments on all Medicaid services except nursing home care.

-- A voluntary Medicare voucher will be established to promote competition among private insurers in the provision of cost-effective coverage. This voucher will allow beneficiaries to choose health insurance plans that best meet their needs at prices they are willing to pay.

-- Between 1985 and 1988, the share of the Medicare Supplementary Medical Insurance program paid by beneficiaries will be increased from 25% to 35% to reduce the subsidy that beneficiaries get from general revenues.

-- Tax subsidies will be limited to employer premium contributions of $175 monthly for a family plan and $70 monthly for an individual plan. These levels will still permit adequate coverage, but will make the tax law neutral between wages and increased health insurance.

FEDERAL CIVILIAN RETIREMENT PROGRAM

Question 1.

Do you think that the increase in the employee contribution from 7 percent of salary this year to 9 percent in 1984 and 11 percent in 1985 is fair?

Answer 1.

We believe that a retirement program with costs equal to those of an average private sector plan, and a plan in which costs are shared equally between the employee and the Government is a fair one.

OPM has estimated that the cost of a retirement program equal in cost to average private sector plans including social security costs would be approximately 22% of payroll. That is, if 22% of payroll is set aside each payday, sufficient funds should be available to pay the benefits under the plan as they come due. Since its inception civil service retirement has had the concept that costs of the program should be shared equally between employer and employee. Accordingly, raising both the agency and employee contribution to 11% produces the requisite 22% of payroll needed to fully fund the system.

FEDERAL CIVILIAN RETIREMENT PROGRAM

Question 2.

What will be the impact of increasing the contribution rate in view of:

a. the 1.3 percent of salary tax increase for medicare coverage this year?

b. the one year freeze in pay?

Answer 2.

In October 1982 employees received a 4% across-the-board pay increase. This pay increase should be considered when assessing the impact of the 1.3% tax for the Health Insurance portion of Social Security, which began for Federal employees shortly thereafter in January 1983.

There is no question that increasing the contribution for retirement in 1984 and 1985 coupled with a one year pay freeze will cause employees to lose some purchasing power. This loss should be offset to some degree by the fact that other pay increases will continue to occur. These include step increases (3%) that just about all employees receive periodically, quality increases and promotion increases. Further, as a result of the Administration's efforts inflation has abated so purchasing power losses during the one year duration of the freeze should not be so marked as it would have been in earlier years when inflation was rampant.

FEDERAL CIVILIAN RETIREMENT PROGRAM

Question 3.

How will the increase in the retirement age affect workers who are now near the early retirement age?

Answer 3.

Those employees who have reached age 55 at time of enactment will not be subject to the early retirment reduction. Those who are already eligible or within 3 years of retirment eligibility will have their annuity computed on the current high 3 year average salary base rather than the proposed high 5 year salary average. In addition, the annuity reduction for employees under age 55 at time of enactment will be phased in over a 10 year period at a rate of 5% per year. That is, an employee who is age 54 at time of enactment may retire at age 55 with a 5% reduction in the annuity or at age 56 with no reduction. If the employee is 53 at time of enactment, he may retire at age 55 with a 10% reduction, at age 56 with a 5% reduction, or at age 57 with no reduction. After the 10 year phase-in period the reduction will be 5% for each year the inidividual is under age 65, providing of course, that he satisfies minimum age and service requirements.

SOCIAL SECURITY

The administration's budget includes the recommendations of the bipartisan social security reform commission.

Question 1:

Under OMB's economic and program assumptions, does the bipartisan package ensure social security solvency beyond the FY 1984 budget year?

Answer:

Under 1984 budget assumptions, the bipartisan package would ensure the solvency of social security through 1988 and beyond.

Question 2:

Do you anticipate a need to borrow from the disability or hospital insurance trust funds?

Answer:

It is anticipated that OASI will have to borrow from the DI trust fund, but, under budget assumptions, borrowing from the HI trust fund will not be needed. The attached tables show the status of the OASI and DI trust funds.

Question 3:

If yes, what does this do to the solvency of the hospital insurance trust fund?

Answer:

Not applicable.

Status of the Trust Funds - 1984 President's Budget
OASI Trust Fund - Proposed Law ($ in millions)

Fiscal Year	SOY Balance	Income	Outlays	EOY Balance	SOY Balance As a % of Outlays
1982 (Actual)	23,845	126,629	137,929	12,545	17.3%
1983	12,545	166,203	152,587	26,161	8.2%
1984	26,161	149,971	162,817	13,315	16.1%
1985	13,315	181,342	176,076	18,581	7.6%
1986	18,581	201,416	189,504	30,493	9.8%
1987	30,493	221,644	203,778	48,359	15.0%
1988	48,359	256,442	218,525	86,276	22.1%
1989	86,276				

Status of the Trust Funds - 1984 President's Budget
DI Trust Fund - Proposed Law ($ in Millions)

Fiscal Year	SOY Balance	Income	Outlays	EOY Balance	SOY Balance As a % of Outlays
1982 (Actual)..........	3,394	21,398	18,035	6,757	18.8%
1983..................	6,757	18,468	17,903	7,321	37.7%
1984..................	7,321	25,972	17,943	15,349	40.8%
1985..................	15,349	21,070	18,382	18,038	83.5%
1986..................	18,038	22,061	19,120	20,979	94.3%
1987..................	20,979	24,321	20,017	25,283	104.8%
1988..................	25,283	26,936	21,085	31,134	119.9%
1989..................	31,134				

Status of the Trust Funds, 1984 President's Budget
OASDI Trust Funds - Proposed Law ($ in Millions)

Fiscal Year	SOY Balance	OASI Income	DI Income	OASDI Income	OASI Outlays	DI Outlays	OASDI Outlays	EOY Balance	SOY Balance A % of Outlay
1982 (Actual)............	27,239	126,629	21,398	148,027	137,929	18,035	155,964	19,302	17.5%
1983.....................	19,302	166,203	18,468	184,671	152,587	17,903	170,490	33,483	11.3%
1984.....................	33,483	149,971	25,972	175,943	162,817	17,943	180,760	28,666	18.5%
1985.....................	28,666	181,342	21,070	202,412	176,076	18,382	194,458	36,620	14.7%
1986.....................	36,620	201,416	22,061	223,477	189,504	19,120	208,624	51,473	17.6%
1987.....................	51,473	221,644	24,321	245,965	203,778	20,017	223,795	73,643	23.0%
1988.....................	73,643	256,442	26,936	283,378	218,525	21,085	239,610	117,411	30.7%
1989.....................	117,411								

STRUCTURAL DEFICITS AND POLICY GOALS

Question: If most of the budget deficit in FY 1988 is "structural" and, therefore, should be eliminated, why does the President's budget propose options for eliminating only 60 percent of the "structural" deficit? In fact, by FY 1988, the budget deficit is still over 2.0 percent of GNP which is about where we were during the 1970's. Why is this now an acceptable goal?

Answer: The Administration remains committed to the goal of a balanced budget and will propose additional policy action, as needed, to achieve it. The most important step toward eliminating the deficit is putting in place the President's fiscal 1984 budget freeze and reform plan.

This plan, if enacted, would reduce the deficit from 7.0% of GNP in the current fiscal year to just 2.6% of GNP by 1988. If the Congress enacted further spending restraints, that percentage would be reduced even more.

Similarly, a stronger economic recovery would also eliminate the deficit. If average real GNP growth were 1.33% higher each year over the next 6 years, compared to the Administration's prudent projections, the proposals in the 1984 Budget would be sufficient to achieve a balanced budget by 1988.

To increase the likelihood of such a recovery, we must show the country and the financial markets that deficits are on a downward path; the 1984 fiscal plan does just that.

NON-DEFENSE DISCRETIONARY PROGRAMS

Mr. Stockman, the President's budget proposes an aggregate freeze on the so-called "non-defense discretionary" programs. According to the budget document, the freeze is in terms of budget authority. Within the aggregate freeze total, some programs grow, some stay the same, and some are reduced. The budget document shows that for on-budget programs, this freeze saves $6.2 billion in outlays in FY 1984.

Recently, our staff had CBO price out on a preliminary basis a freeze on budget authority for non-defense discretionary programs assuming that the freeze would generally be applied to each line item. CBO's preliminary estimate was that such a freeze would save about $2 billion in FY 1984 outlays. While there may be some technical differences in the estimates, it appears you are proposing a much greater cut in FY 1984 outlays than an item-by-item freeze would imply. As we mark up our budget resolution, we will need to know more about your proposals for this part of the budget.

Question:	Doesn't the fact of the deeper outlay cuts in FY 1984 imply that you have really proposed something greater than an aggregate freeze on these programs?
Answer:	Differences between Administration and CBO outlay estimates of the magnitude you mention need not imply any substantive differences in assumptions about freeze levels at all. The Administration chose budget authority as a measure of program level because budget authority is a much better indicator of the resources actually available to program managers to carry out planned programs. Estimates of outlays are imprecise because they measure, in advance, the speed with which these resources are committed and bills are paid by those same program managers. Reasonable people can disagree on this for reasons that have nothing to do with program levels. Since our budget authority request for non-defense discretionary programs in 1984 is $2 billion higher than the 1983 current services level, one could just as easily conclude that the budget proposes something slightly less than an aggregate freeze on these programs.
Question:	While I recognize that individual programs may go up or down, shouldn't the concept of a freeze for budget resolution purposes assume that outlays in the aggregate would be held to a level commensurate with an item-by-item freeze on budget authority?

Answer: The President's annual Budget includes specific information at the account level, and the outlay estimates at that level are kept commensurate with whatever assumptions are made for the budget authority -- whether the assumptions are for a freeze, an increase, or a reduction. The Budget Resolution estimates are, by design, not tied to specific details to avoid jurisdictional conflicts with Authorizing and Appropriations Committees. Therefore the relationship between budget authority and outlay estimates in the Budget Resolution is less precise and can assume whatever the Congress decides is appropriate. The underlying account level detail supporting the resolution provides identification of cases where the budget authority and outlays are assumed to differ from an item-by-item freeze on budget authority. This, in fact, is how the discretionary freeze in the budget resolution for 1983 worked.

Question: Can you furnish the Committee a total listing of all budget accounts that you define as non-defense discretionary, together with FY 1983-88 estimates of budget authority and outlays for these accounts, both in the current services baseline and in the President's budget request?

Answer: Yes. A computer report showing this information by agency, bureau, and account is being sent separately.1/

Question: Can you furnish the Committee an explanation of how your current services baseline for these accounts was constructed?

Answer: Yes. OMB Bulletin 83-9, which provided instructions to Government agencies on construction of current services estimates for the 1984 Budget, is being sent separately. General guidelines are also provided in OMB Circular No. A-11, Secs. 27.1-27.3. A copy of these sections is also being sent separately.

1/ Retained in committee files.

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

December 27, 1982

BULLETIN NO. 83-9

TO THE HEADS OF DEPARTMENTS AND ESTABLISHMENTS

SUBJECT: Submission of Revised Current Services Estimates for the 1984 Budget

1. Purpose. This Bulletin provides instructions for the preparation and submission of revised current services estimates for fiscal years 1983 through 1988.

2. Background. OMB Bulletin No. 83-1 provided instructions concerning the initial submission of current services estimates for fiscal years 1983 through 1988. Sections 27.1-27.3 of OMB Circular No. A-11 provide instructions for the preparation of current services estimates.

In addition, revised current services credit estimates are required for agency transactions financed by or through the Federal Financing Bank and for the lending activities of the Rural Electrification Administration. Sections 33.4 and 33.5 of OMB Circular No. A-11 provide general instructions for the preparation of credit data.

3. Basis for the estimates.

a. Current services base estimates for fiscal year 1983. Current services base estimates for fiscal year 1983 will reflect final economic assumptions and completed Congressional action.

In particular, the effects of the following should be incorporated into the 1983 current services base:

-- The final economic assumptions for the 1984 Budget that will be provided by OMB.

-- Legislation enacted during the lame-duck session of the 97th Congress. In the absence of enacted appropriations, the 1983 current services base should be derived from the annualized rates of budget authority and the estimated outlays that result from the continuing resolution in effect at the close of the 97th Congress. Discretionary programs should not include an inflation adjustment to the 1983 budget authority levels contained in enacted appropriations or derived from the continuing resolution.

-- Debt collection activities and the sale of surplus property, as authorized under current law.

Current services base estimates should include the effect of the October 1, 1982, pay raise and the agency's share of the Medicare Hospital Insurance tax beginning on January 1, 1983. (They should be included, for fiscal year 1983, on the appropriate pay supplemental line entries.) The 1983 estimates will reflect the agency's absorption of the October 1982 pay raise and the agency's share of the Medicare Hospital Insurance tax resulting from the guidance in OMB Bulletin No. 83-7 that was required in the fiscal year 1984 budget decisions.

b. Current services estimates 1984-1988. These estimates will reflect the continuation of on-going Federal programs and activities at 1983 current year, current services base levels without policy changes and will be consistent with the final economic assumptions to be provided by OMB.

The 1984-1988 estimates should reflect the full effect of the October 1982 pay raise and the full year amount of the agency's share of the Federal employee payroll tax for Medicare Hospital Insurance that goes into effect January 1, 1983.

For nonpay-related programs, the instructions in attachment A will be used to adjust current services estimates for the effects of assumed future inflation. Exhibit 1 applies these instructions, using hypothetical price measures, to an account that includes pay-related expenses, grants to States and localities, construction programs, and nonpay Federal purchases. Budget authority for nongrant activities should be based on the deflator supplied by OMB that most accurately reflects future prices to be experienced by the Federal Government for such activities. The use of any other deflator must be approved in advance by OMB. The agency must demonstrate to OMB that different inflation rates are expected for the program and that these rates are consistent with the projected inflation rates in the broader deflators supplied by OMB.

4. Materials required. OMB will provide the agencies with final economic assumptions for 1983 through 1988 and copies of computer listings for revising the current services estimates by January 3, 1983. A separate computer listing will contain information on certain credit activities. Agencies will revise the estimates and prepare the summary table and other supporting materials required by section 27.3 of OMB Circular No. A-11. Agencies also will prepare supporting information for current services credit estimates in accordance with the instructions contained in attachment B and in the format of exhibit 2.

Agencies furnishing revised estimates to OMB via computer terminals will use these terminals to enter the requested information. However, for credit activities the required information will be submitted on the computer listings. All other agencies will mark up and return the computer listings. The current services budget authority and outlay data will be entered into Record Type "S/T" for 1983 through 1988. The current services receipts estimates will be entered into Record Type "K" for 1983 and 1984 and into Record Type "M" for 1985 through 1988.

Agencies will submit with the current services estimates a brief description of estimating methodology used and an identification of the deflator(s) used in making the estimates for each account or group of similar accounts.

5. Timing. Agencies will submit two (2) copies of the required materials to OMB no later than January 10, 1983. However, the summary table that shows a bridge between the current year, current services base estimates and the budget year current services estimates will be submitted subsequently at the request of OMB.

6. Inquiries. Inquiries should be directed to the OMB representative responsible for reviewing the agency's budget estimates.

David A. Stockman

David A. Stockman
Director

Attachments

Attachment A
Bulletin No. 83-9

Guidelines for Adjusting Current Services Estimates for the Effects of Future Inflation

The following guidelines will be used for adjusting current services estimates to reflect the effects of future inflation on current services estimates for budget authority, outlays, and offsetting collections. Exceptions to the inclusion of future inflation in the estimates are listed in section 27.2(b)(2) of OMB Circular No. A-11.

1. If a program contains pay-related items, separate the program into nonpay budget authority and pay-related budget authority. Only the nonpay budget authority is to be adjusted for inflation.

2. Select the most appropriate deflator from the alternative price measures supplied by OMB.

3. If the program is comprised, in part or entirely, of grants to State and local governments, the budget authority for the grant portion should be based on the deflator that most appropriately reflects future prices to be experienced at the State and local level. The following general criteria for grants deflators are appropriate:

-- General purpose grants--the State and local purchases deflator.

-- Grants for payments to individuals--the consumer price index.

-- Grants for construction programs--either the State and local purchases deflator, the GNP deflator, or the Federal nonresidential construction deflator.

4. Budget authority for nongrant activities should be based on the deflator supplied by OMB that most accurately reflects future prices to be experienced by the Federal Government for such activities. The use of any other deflator must be approved in advance by OMB. The agency must demonstrate to OMB that different inflation rates are expected for the program and that these rates are consistent with the projected inflation rates in the broader deflators supplied by OMB.

5. After selecting an appropriate deflator, adjust the 1984-1988 budget authority for nonpay in each year upward by the cumulative percentage increase in the deflator since fiscal year 1983. Combine the adjusted nonpay budget authority with the unadjusted pay-related budget authority to obtain the estimated current services budget authority for the entire program.

6. Outlays should be estimated on the basis of standard spendout formulas using the budget authority levels calculated above; that is, outlays in a given year should be the sum of first-year spendout from that year's budget authority plus spendout from prior-year balances.

7. Offsetting collections and other program revenues should be adjusted for inflation in a similar fashion if the level of anticipated receipts is expected to vary with price levels.

Exhibit I
Bulletin No. 83-9

HYPOTHETICAL PRICE MEASURES
(percentage change; fiscal year over fiscal year)

Fiscal Year	GNP Deflator	State and Local Purchases Deflator	Federal Nondefense Nonpay Purchases Deflator	Federal Nonresidential Construction Deflator
1983....	6.8	7.0	6.0	6.0
1984....	6.0	6.0	5.0	6.5
1985....	5.0	5.0	4.0	6.5
1986....	4.2	4.0	3.5	5.0
1987....	3.3	3.0	3.0	4.5
1988....	3.0	3.0	3.0	4.0

The following pages contain hypothetical applications of these price measures and other required adjustments to several program examples.

Exhibit 1 (Cont.)

ADJUSTMENT OF CURRENT SERVICES BUDGET AUTHORITY ESTIMATES FOR FUTURE INFLATION (continued)
(dollar amounts in thousands)

	Current Services Base 1/	Current Services Estimates				
	1983	1984	1985	1986	1987	1988
Construction program BA (in FY 1983 prices).....	45,000	120,000	60,000	20,000	10,000	0
Percent change in Federal non-residential construction deflator:						
Annual...........	(N/A)	(6.5)	(6.5)	(5.0)	(4.5)	(4.0)
Cumulative.......	(N/A)	(6.5)	(13.4)	(19.1)	(24.5)	(29.4)
Inflation adjustment......	0	7,800	8,054	3,819	2,445	0
Adjusted construction program BA..........	45,000	127,800	68,054	23,819	12,445	0
Nonpay Federal purchases BA (in FY 1983 prices).....	100,000	100,000	103,000	98,000	97,000	97,000
Percent change in Federal non-defense nonpay purchases deflator:						
Annual...........	(N/A)	(5.0)	(4.0)	(3.5)	(3.0)	(3.0)
Cumulative.......	(N/A)	(5.0)	(9.2)	(13.0)	(16.4)	(19.9)
Inflation adjustment......	0	5,000	9,476	12,762	15,920	19,308
Adjusted nonpay Federal purchases BA.................	100,000	105,000	109,476	110,762	112,920	116,308

Exhibit 1 (C

ADJUSTMENT OF CURRENT SERVICES BUDGET AUTHORITY ESTIMATES FOR FUTURE INFLATION
(dollar amounts in thousands)

	Current Services Base 1/	Current Services Estimates				
	1983	1984	1985	1986	1987	1988
Pay-related BA (FY 1983 prices)....	20,000	20,000	20,000	20,000	20,000	20,000
Federal hospital insurance costs (agency share) 2/3/.	88	234	234	234	234	234
4% October 1982 pay raise 3/........	400	800	800	800	800	800
Adjusted pay-related BA..........	20,488	21,034	21,034	21,034	21,034	21,034
Grant BA (FY 1983 prices)............	70,000	70,000	70,000	70,000	70,000	70,000
Percent change in State and local purchases deflator:						
Annual............	(N/A)	(6.0)	(5.0)	(4.0)	(3.0)	(3.0)
Cumulative........	(N/A)	(6.0)	(11.3)	(15.8)	(19.2)	(22.8)
Inflation adjustment.......	0	4,200	7,910	11,025	13,440	15,960
Adjusted grant BA..................	70,000	74,200	77,910	81,025	83,440	85,960

1/ Enacted or continuing resolution level.
2/ Effective January 1, 1983.
3/ In this example the 1983 estimate reflects 50% absorption.

ADJUSTMENT OF CURRENT SERVICES BUDGET AUTHORITY ESTIMATES FOR FUTURE INFLATION (continued)
(dollar amounts in thousands)

	Current Services Base 1/	Current Services Estimates				
	1983	1984	1985	1986	1987	1988
Account total BA (FY 1983 prices)....	235,000	310,000	253,000	208,000	197,000	187,000
Total adjustments............	488	18,034	26,474	28,640	32,839	36,302
Adjusted account total BA............	235,488	328,034	279,474	236,640	229,839	223,302
Outlays:						
Spend out from prior-year BA.......	50,000	47,098	65,607	55,895	47,328	45,968
Spend out from new BA..............	188,390	262,427	223,579	189,312	183,871	178,642
Total outlays....	238,390	309,525	289,186	245,207	231,199	224,610

Attachment B
Bulletin No. 83-9

Supporting Information for Current Services Credit Estimates

Additional detailed credit data are required to develop long-range current services credit estimates for off-budget Federal entities. This applies only to agency transactions financed by or through the Federal Financing Bank and for the lending activities of the Rural Electrification Administration.

The conceptual approach for current services credit data should be consistent with that described for other current services estimates. For fiscal year 1983, current services credit data will reflect completed Congressional action; for this year, discretionary programs should not be adjusted for inflation. Estimates for 1984-1988 will reflect the continuation of on-going Federal programs and activities at 1983 current services base levels without policy changes and will be consistent with the final economic assumptions to be provided by OMB. For these years, discretionary programs should be adjusted for inflation occurring after 1983.

Two (2) copies of the supporting information for current services credit estimates will be submitted in the format of exhibit 2 using line numbers listed below. (These line numbers are described in sections 33.4 and 33.5 of OMB Circular No. A-11.)

Position with respect to limitation on obligations:

Line 1110	Limitation on obligations
Line 1130	Obligations exempt from limitation
Line 1151	Direct loans to the public
Line 1152	Repurchases of loan assets from the FFB
Line 1190	Unused balance of limitation, expiring

Position with respect to limitation on commitments:

Limitation on commitments:

Line 2111	Loans by private lenders
Line 2112	Loans by the FFB
Line 2131	Loans by private lenders
Line 2132	Loans by the FFB

New commitments made, gross:

Line 2151	Loans by private lenders
Line 2152	Loans by the FFB
Line 2153	Loans sold to the FFB
Line 2190	Unused balance of limitation, expiring

Exhibit 2
Bulletin No. 83- 9

SUPPORTING INFORMATION FOR CURRENT SERVICES CREDIT ESTIMATES
(dollar amounts in thousands)

Identification code 11-1082-0-1-152	1983	1984	1985	1986	1987	1988
Position with respect to limitation on obligations:						
1110 Limitation on obligations....	750,000	787,500	821,250	853,500	885,750	917,250
1130 Obligations exempt from limitation..................						
Obligations incurred, gross:						
1151 Direct loans to the public...	750,000	787,500	821,250	853,500	885,750	917,250
1152 Repurchases of loan assets from the FFB................						
1190 Unused balance of limitation, expiring....................						
Position with respect to limitation on commitments:						
Limitation on commitments:						
2111 Loans by private lenders....						
2112 Loans by the FFB............	3,083,500	3,237,675	3,376,432	3,509,023	3,641,614	3,771,120
Commitments exempt from limitation:						
2131 Loans by private lenders....						
2132 Loans by FFB................						
New commitments made, gross:						
2151 Loans by private lenders....						
2152 Loans by FFB................	3,083,500	3,237,675	3,376,432	3,509,023	3,641,614	3,771,120
2153 Loans sold to the FFB.......						
2190 Unused balance of limitation, expiring.......						
Addendum: Federal Financing Bank transactions						
1330 Direct loans sold to the FFB........................						
1350 Repayments..................						
1430 New loan disbursements......	3,083,500	3,237,675	3,376,432	3,509,023	3,641,614	3,771,120
1450 Repayments..................	-686,700	-705,700	-722,580	-874,140	-1,010,400	-1,097,160

NOTE: For FFB repayments (lines 1350 and/or 1450), estimates should be consistent with the loan disbursement levels (lines 1330 and/or 1430).

Current Services Estimates

27.1. General instructions.

Under section 605 of the Congressional Budget Act of 1974 (P.L. 93-344), the President is required to submit to the Congress each year the estimated outlays and proposed budget authority that would be included in the budget if all programs and activities were carried on at the same level as the fiscal year in progress and without policy changes in such programs and activities. This current services information, together with supporting information such as economic assumptions and program caseloads, will be used to assess the size and direction of the budget and as a base against which alternatives, including the President's budget proposals, can be evaluated. For this purpose, each agency, including the legislative branch, the judiciary, and the off-budget Federal entities, will prepare and submit estimates, with related supporting materials, of the budget authority and outlay amounts that would result if all Federal programs and activities were continued through BY+4 at the current year level (without policy changes).

27.2. Basis for the estimates.

(a) *Current year, current services base.*—The current year, current services base will be derived from the current year amounts included in the regular budget schedules, but will not include those supplementals and legislative proposals included in the budget that would result in programmatic changes for the current year, i.e., amounts attributable to proposed new or expanded activities or the reduction or termination of ongoing activities. In addition to legislative proposals, both proposed management initiatives and administrative actions are also considered to be policy changes and, therefore, their effects on the budget estimates will *not* be reflected in the current services estimates. (Pay raise supplementals for the pay raise that will become effective on October 1 of the current calendar year will be included as separate entries, for both budget authority and outlays (see exhibit 27)).

Estimates of budget authority and outlays for the current year current services base will be consistent with the current year amounts reported in section A of the supplementary source data for the account (see section 25), unless current year appropriations have not been enacted. In the absence of completed appropriation action, the following rules will apply: (a) for major procurement and construction programs that are governed by amounts contained in annual authorizing legislation, estimates will be based on the appropriations that would be required to permit the orderly execution of enacted authorizing legislation, and (b) for other purposes, estimates will be calculated at the annual rate of the level contained in the continuing resolution in effect.

(b) *BY through BY+4 current services estimates.*—The current services estimates for the budget year and the 4 succeeding years should reflect anticipated costs of continuing ongoing Federal programs and activities at the current year current services base levels without policy changes, i.e., excluding all pending new legislative and administrative proposals, Presidential and congressional. The estimates should allow for the expected future implications of current law and for anticipated changes of a relatively uncontrollable nature, as distinct from policy changes. More specifically:

(1) Programs that expire under existing laws should not be assumed to carry forward if the program is clearly temporary (such as a temporary study commission). Recurring programs requiring periodic reauthorizations will be assumed to continue, unless there are reasons other than changes in policy to believe that a program will not be renewed. In such cases, amounts will not be included in the current services estimates. Examples of such nonrecurring activities are refugee assistance, countercyclical economic assistance, disaster assistance for specific incidents and energy crisis assistance. Questionable or borderline cases should be referred to OMB representatives.

(2) Estimates (except for pay and related costs as discussed in (3) below) will reflect price adjustments consistent with the economic assumptions provided by OMB. Price adjustments will be included for all programs (including benefit programs without automatic cost-of-living adjustments) unless there is a clear presumption in current law that such adjustments should not be made.

These exceptions include the following:

—programs that are financed by a level of budget authority (e.g., contract authority) that is specified in existing law;

—programs that are financed under legally mandated formulas that are not normally adjusted for price changes (e.g., shared revenue);

—programs that are financed by advance appropriations;

- —programs that are affected by a mandated budget authority or outlay ceiling that precludes funding increases to reflect consideration of price increases; and
- —programs that are financed by permanently appropriated receipts.

(3) Resources for personnel compensation will be reflected at the lowest level required to maintain the current activity and program level. Productivity increases will be assumed to offset growth in workload except for major changes that are mandatory under current law. Other exceptions are permissible only when the authorizing statutes specifically provide for either rising or declining employment. Such exceptions must be approved in writing by OMB.

Effects of future Federal pay increases beyond the increase for the current year will not be included in estimates prepared by the agencies. A separate Government-wide allowance will be developed by OMB for each of the years involved.

(4) Estimated budget authority for all other Federal activities, such as caseload programs, construction, procurement, operations and maintenance, loans, and subsidies, should be based on a constant level of activity reflected in the current year current services base estimates unless changes are required by current law. Estimated budget authority and outlays under these programs should reflect consideration of the effect of anticipated price changes, as specified above. In general, estimated budget authority and outlays for major projects (e.g., the space shuttle and major weapons systems) will be determined by following approved construction, development, and/or procurement schedules. However, in cases where the approved construction schedule is usually not met due to constrained appropriation levels, the same budget authority level will be assumed that was included in the current year current services base. Outlays will be consistent with that amount of budget authority for each year during BY through BY+4 plus the appropriate spend-out of balances of prior year budget authority.

(5) Current services estimates for the period beyond the budget year will include the effect of *enacted* legislation. These estimates will reflect programs or activities that will commence, be terminated, or be superceded at any time during BY+1 through BY+4 in the appropriate years. Examples include:

- —recently enacted changes in entitlement programs that change a formula or qualification for such entitlements at a future date;
- —enacted consolidation of grant programs that will occur beyond the budget year as well as specifically enacted changes for certain activities that are included in a particular grant program.

(6) Public works programs that are normally constrained by annual appropriations should be projected at the budget authority levels in the current year plus adjustments for anticipated inflation. However, large separately funded public works (such as power authority generating or distribution capacity) should be permitted to phase down following an orderly construction schedule. Budget authority for new additional, large, discrete projects should not be assumed.

(7) Unique major projects such as the space shuttle should be phased out of the estimates according to existing construction plans, without offsetting increases in other activities.

27.3. Materials required.

(a) *Revised computer listings.*—OMB will provide each agency with copies of the current services computer listing (exhibit 27) to be completed and returned as described in section 25.1. Subsequently, the data will be revised and resubmitted as necessary.

Current services estimates will be prepared for each budget account that has a transmittal code of "0" (see section 21.3); and for supplemental requests that are *mandatory* under existing law (e.g., payments under entitlement programs) with transmittal codes of "1", "4", "6" to reflect *current year* current services estimates of budget authority and the related outlays. No budget authority will be shown in the BY through BY+4 current services columns for these supplementals. However, the spendout of current year budget authority will be reflected, where appropriate, in the BY through BY+4 columns. Current services estimates are not required for list accounts included in the budget under transmittal codes of "2", "3", "5", or "7", unless specifically requested by OMB. Data for current services estimates will be entered in the various columns as indicated below:

Column	Description
Function	For accounts within a single function, enter the appropriate code (last three digits of the identification code) on each line entry under budget authority and under outlays. For accounts classified in more than one function or subfunction (the last two digits of the identification code will be "00", "50", "70", or "99"), the appropriate subfunctional code will be entered on each line as appropriate.
Line No.	Enter the appropriate budget authority line code from the program and financing schedule for each type of authority (see section 32.3). This code will also distinguish current authority (lines 40.00 or 43.00 through 50.00) and permanent authority (lines 60.00 or 63.00 through 69.00). When lines 43.00 or 63.00 appear on the program and financing schedule, no entries will be shown for lines 40.00, 41.00, or 42.00, and 60.00, 61.00, or 62.00. Under outlays, enter the appropriate code (lines 90.00 through 91.30) from the program and financing schedule.
G/N *These entries must be consistent with estimates included in supplementary source data and multi-year planning estimates.*	This column is applicable to each entry for budget authority and outlays. Enter "G" to indicate amounts of grants-in-aid to State or local governments. Enter "N" to indicate amounts for direct Federal programs, including loans and repayable advances to State and local governments. Use "G" only when the sixth digit of one or more of the character classification codes assigned to the account is "1" or "2" (see Appendix A).
Amount columns	Complete these columns to show data at the lowest level of classification reflected in the preceding columns.

(b) *Supporting materials.*—Two copies of an agency summary table will be submitted to provide a bridge between the current year current services base estimates and the budget year current services estimates. This table should identify, as separate stub entries, major budget authority or outlay differences ($50 million or more) between the current year current services estimates and the budget year current services estimates. These differences should be explained in terms of:

(1) Effects of enacted authorizations, appropriations, and other legislation.

(2) Expiration of temporary programs,

(3) Price adjustments, as specified in section 0.2.

(4) Prior year contracts and obligations,

(5) Anticipated changes in relatively uncontrollable programs or receipts (including offsetting receipts).

Agencies should also be prepared to furnish, upon request, additional information, such as caseload estimates, pricing assumptions, and methodology in support of the current services estimates.

MONETARY POLICY

QUESTION

Mr. Stockman, despite all of the decline in interest rates in recent months, the interest rates that business and consumers pay are still extremely high, especially compared to the sharp decline in inflation.

1. How can interest rates continue to decline, with the big budget deficits the President proposes?
2. In fact, the Treasury will finance over $59 billion in new net borrowing this quarter, and interest rates have ticked up. Is it possible that interest rates could rise now, when the recovery is just getting started?

ANSWER

Interest rates can continue to decline if excessive growth of the money stocks is avoided, if inflation remains under control, and if government deficits are reduced. The Administration budget calls for a progressive reduction in the Federal deficits and is therefore consistent with a long-term decline in interest rates.

ECONOMIC GOALS

QUESTION

The President's FY 1984 budget sets out his long-term economic goals.

1. Why do you believe 10 percent unemployment in 1984 and nearly 9 percent unemployment in 1985 to be appropriate goals?
2. Why should the Congress accept these very high levels of unemployment as "the best that we can do"?
3. What would be the costs of attempting to reduce the unemployment rate more rapidly?

ANSWER

These unemployment rates are not the Administration's goals, but are merely projections consistent with our economic assumptions.

We do not accept such high unemployment as the best that can be done. The Administration has several initiatives to reduce unemployment.

- 1984 will be the first year of full implmentation of the Job Training Partnership Act (JTPA), which gives $1.9 billion to the States for training disadvantaged youth and adults. Business will have a major role in seeing that this money is well spent.
- A new JTPA program of job search, job training, and relocation assistance will expand almost 10 fold to $240 million funds to help almost 100,000 experienced workers who have lost their jobs due to plant closings and other structural causes.
- The President is proposing legislation so that unemployed workers eligible for Federal Supplemental Compensation could get vouchers which would entitle an employer hiring them to a tax credit -- thus providing an incentive to hire the long-term unemployed.
- A separate legislative proposal would permit States to use a portion of their unemployed insurance tax receipts for training, job search and relocation for unemployed workers
- To help young people under age 22, the Administration proposes a youth opportunity wage 25 percent below the regular minimum wage to be applicable from May 1 to September 30. This will help young people to get the on-the-job training and experience to increase their earnings.

Congress can help in reducing unemployment by passing this legislation and by helping us to reduce the deficit in accordance with the President's program so that investment funds will be available and inflation will not be reignited.

NATIONAL DEFENSE -- PROBLEM OF DIFFERENT BASELINES

Q. How did you derive your baseline for measuring savings or increases in National Defense? Does it differ from the approach used in other functions. If so, why?

A. The baseline for the Department of Defense is the Administration February 1982 defense request, which corresponds to a "current policy" baseline for defense. This is consistent with our approach last year in defining the baseline as "Current Services plus adequate defense." In fact, last year the Budget committees also adopted a similar baseline.

Q. The President's budget shows a reduction in FY 1984 of $11.3 billion in budget authority and $8.4 billion in outlays from your current services baseline. Over the next five years, outlay savings of $47 billion are claimed. Could you tell what programs are being cut to arrive at those totals? How much of the reduction is taken from military pay and from DOD civilian pay?

A. The $47 billion in defense spending includes about $27 billion in revised inflation. As a consequence, there is a reduction in funding across essentially all DOD programs. Every Program Manager will be given less money to meet his objectives--purchase systems, meet program milestones, etc. Because of our success in bringing down inflation for the general economy, we anticipate that he should be able to meet his objective with less funding.

It, nonetheless, is a real savings in dollars from our previously anticipated requirements--just as real as outright cancellations of major systems, but much less devastating to national security.

Secretary Weinberger has also made some specific program cuts and changes in his review of the FY 1984 budget which net to about $2.0 billion in reductions.

The savings from military and civilian pay raises amounts to about $18 billion.

NATIONAL DEFENSE -- PROBLEM OF DIFFERENT BASELINES

Q. If you used a different base, perhaps last year's Budget Resolution estimates for FY 1984 and FY 1985, would you still maintain that some reductions have been made in defense? Isn't it correct that the Administration's defense estimates, after the reductions you claim are taken into account, are still higher than the Budget Resolution levels the Congress adopted last year for fiscal years 1984 and 1985?

A. Of course, if a different baseline is assumed, the differences from that baseline would be different.

If we compare the FY 1983 Budget Resolution allocation of DOD military, the resolution called for reductions of $-11.1 billion and $-14.7 billion in FY 1984 and FY 1985, respectively. The Administration's DOD budget request reflects savings of $8.4 billion and $8.0 billion, respectively.

	FY 1984		FY 1985	
	BA	O	BA	O
	($ in billions)			
DOD Military				
1983 Budget Resolution	271.7	235.9	315.0	270.8
FY 1984 Admin Request	273.4	238.6	321.6	277.5
Difference	-1.7	-2.7	-6.6	-6.7
Function 050				
FY 1983 1st Budget Resolution	279.5	243.3	323.6	279.0
FY 1984 Admin. Request	280.5	245.3	330.0	285.3
Difference	-1.0	-2.0	-6.4	-6.4

NATIONAL DEFENSE - CURRENT COMMITMENTS ARE WEDGES FOR FUTURE SPENDING

Q. Looking at the projections for defense spending over the next five years and the likely available revenue and deficits, I am concerned that we simply won't be able to afford the defense program now proposed by the President when the bills come due three or four years from now.

Mr. Stockman, as budget director, I know you share my concern as Chairman of the Budget Committee that we flag for attention new proposals that don't involve much initial spending, but have major budget implications later on. (A well known example is the food stamp program.) Do you look at the defense budget and flag for the President's attention defense programs that are "spending wedges" against future budgets?

A. All defense budget authority and outlay projections are based on specific programs as we now perceive them. Thus, there are no unprogrammed wedges included.

There are varying spending rates for the different defense programs, however, we project not only new budget authority but also outlay requirements for each year over a five-year period. Thus, we consider the "outyear" spending as a matter of course.

The other standard practice we have in formulating the defense budget is that we consider the full cost-to-completion for major programs. For example, all programs which are treated in Selected Acquisition Reports required by the Congressional review committees are treated in this way. In fact, no other agency provides as comprehensive a review of long range program cost or as detailed a projection of outyear cost as the Department of Defense.

DEFENSE DEPARTMENT LEASING OF SHIPS

Questions

Last Friday's (February 11) Washington Post contained a front page story which implied that the Navy has created a new tax loophole by leasing certain ships instead of buying them.

1. Is it true that leasing instead of purchasing ships creates additional tax expenditure? How much?

2. Doesn't this practice end up costing the government and the taxpayers more than if the ships were purchased?

3. Why has the navy engaged in this practice?

Answers

1. This approach results in a loss in tax revenues of approximately $1.7 billion over a 25 year period that will be partially offset by receipts generated by this program. The estimates of receipts to be generated have ranged from $1.6 billion in a study performed for the Navy to $.8 billion estimated by the Joint Taxation Committee. Notwithstanding the cost of the financial transaction, national security needs are the dominant factor in this program.

2. Whether or not leasing costs more depends on a variety of factors in addition to tax expenditures. For example, by chartering ships built and converted in accordance with commercial practices the Navy estimates lower expenses, resulting in savings to the Government.

3. The Navy decided to use this method for several reasons:

    a. The TAKX program is one of the major elements of the Administration's program for improving rapid deployment capabilities.

    b. Leasing of these specific ships will result in the needed capability being achieved about 18 months earlier than would be possible through the normal procurement process.

    c. The U.S. Government policy is to maximize use of civilian industry and services. The TAKX program applies that policy, boosting both the merchant marine and shipbuilding industries.

AFTERNOON SESSION

The committee met, pursuant to notice, at 2:10 p.m., in room 6202, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Kassebaum, Boschwitz, Grassley, Kasten, Quayle, Gorton, Chiles, Hollings, Biden, Sasser, Metzenbaum, Riegle, Moynihan and Exon.

Staff present: Stephen Bell, staff director; Gail Fosler, chief economist; Richard N. Brandon, minority staff director; and Kemble Stokes, chief economist for the minority.

Chairman DOMENICI. The hearing will please come to order. Unless there is some serious objection, we will proceed right with the witnesses. I am sure that everyone is on short time up here and has to go elsewhere.

I want to apologize in advance. I have to go to a Rules Committee meeting in about 20 minutes, but we have arranged to have one of our side chair and will certainly be here to listen to the testimony.

OPENING STATEMENT OF CHAIRMAN DOMENICI

It is a pleasure to welcome so distinguished a panel to this committee. Mr. Peter Peterson is currently a partner of Lehman Brothers Loeb Kuhn, Inc., in New York and a former Secretary of both the Treasury and Commerce Departments during the Nixon administration. Mr. Henry Fowler is currently chairman of Goldman Sachs and a former Secretary of the Treasury during the Johnson administration. Mr. Douglas Dillon is currently chairman of the U.S. and Foreign Security Corporation and the ultimate bipartisan because you, Mr. Dillon, were Under Secretary of the State during the Eisenhower administration and Secretary of the Treasury during the Johnson administration.

Together you all have taken upon yourselves the tremendous responsibility of formulating a complete budget proposal. You are to be commended. It is rare that a private group undertakes such a careful analysis of our budget situation and proposes such broadsweeping solutions.

You have also done a great deal to make the American public better informed on budget issues. I believe that an informed public is the ultimate key to sound Federal budget policy.

There are many interesting aspects to your proposal, particularly with respect to defense.

Defense will likely be one of the most hotly contested issues in the coming budget debate. I hope that your remarks will focus on why you believe the defense reductions you have proposed to be prudent, which areas of defense you believe should be held down, and the effect of your proposals on our national defense objectives.

Again, I would like to thank you for your efforts to be with us this afternoon. My colleagues and I have a great many questions so I urge each of you to restrict your opening remarks to 15 minutes each. We will have another panel beginning at 3:30 p.m., so we will have to use our time efficiently. For this reason, I suggest that we impose the 3-minute rule for all Senators until we have finished the first round of questions.

What is your preference in terms of presenting the testimony?

Mr. PETERSON. Mr. Chairman, what we would like to do is perhaps make an introductory summary. We have brought some charts with us that we can refer to very briefly, but we thought you might have some questions about some of our numbers so we brought the material here so we can be responsive to any questions you have.[1]

Chairman DOMENICI. You are going to lead off?

Mr. PETERSON. Yes, if that is agreeable.

Mr. FOWLER. I have no prepared statement, Mr. Chairman. I might make a few remarks but not more than a minute or two.

Chairman DOMENICI. Well, let me just say this. As chairman of this committee I am sure I speak for everyone here when I say that we commend you for the way you have gone about your work in the genuine bipartisan approach. You have put together a very comprehensive approach to what you perceive to be a very major American problem, perhaps as major as anything we have had in many a decade.

We commend you for it and we certainly are going to listen to you and hope that from time to time even after this hearing that the committee and/or its members can call upon some of you or all of you for further advice.

With that, then we will proceed. Do you have any idea how long you would like to take for your opening remarks?

Mr. PETERSON. I think I can get through this in 10 minutes or so.

Chairman DOMENICI. We will make whatever prepared statements you have a part of the record at this point, but you proceed.[2]

STATEMENT OF PETER PETERSON, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, LEHMAN BROS., LOEB KUHN, INC., AND FORMER SECRETARY OF THE DEPARTMENTS OF THE TREASURY AND COMMERCE

Mr. PETERSON. Thank you, Mr. Chairman.

As you might imagine, Mr. Chairman, when you have 500 supporters across most of the political spectrum, you want to be very careful that you do not speak on their behalf. Since the President's program has just come out, clearly we have not had the opportunity to canvass our supporters so that it will not be possible to do anything more as far as they are concerned other than simply compare the program of the President's to the bipartisan program.

However, it might be useful at the outset to say, Mr. Chairman, that this experience has been a very interesting one for all six of us. We have gotten a chance to get the mood and the feelings of Americans in leadership positions across many aspects of the political spectrum and we find a consensus that I would like to, at least briefly, summarize.

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[1] See p. 274.

[2] See p. 260.

ECONOMY IS A WORRY IN MANY IMPORTANT PLACES

There is more than a consensus. There is a worry in many important places that not only is our economy in short-term trouble but it is in long-term trouble.

The short-term problems obviously must get attention and they do get attention; however, we want to remind you that quite frequently we seem to react to whatever is public enemy No. 1, at that moment, whether it be high unemployment or high inflation or high interest rates or whatever.

And while we understand that, we would also like to emphasize the long-term economic health of this country. I think many Americans know that the American economy has been in a slide for quite a few years. They worry about what happens if we let this slide continue. They worry about what kind of a country we will become.

So the challenge, Mr. Chairman, is to somehow do something about this serious current malaise but to do it in such a way that we also face our long-term predicament.

Certainly, the overwhelming consensus that we find, at least, is that spending is out of control, that many of these programs were bred in an era of plenty where we thought we could afford almost anything. We are cheating the future. We are mortgaging it with incredibly large unfunded, so-called uncontrolled liabilities and so-called contractual obligations and the like that really involve mortgaging our future.

INVEST MORE IN ECONOMIC FUTURE

I think there is a second recognition, a consensus across America that we must invest more in our economic future if we are going to preserve it. As we look, for example, at the Japanese versus us and in some of the material I will leave with you [1] there is not any question that in the decade of the 1970's for example in plant and equipment, they put nearly 10 percent net of their GNP into plant equipment, robots, and we put 3.5 percent. They put more in research and development.

In public infrastructure which was clearly crumbling in the United States during the 1970's, you may not be aware of the fact that they spent seven times more of their GNP during the 1970's on public infrastructure.

NO PAINLESS CURES

I think there is another consensus across America that there are no miracle, instant, painless cures, whether supply side or otherwise, and that some very painful choices need to be made by America today.

Certainly one brute question is whose consumption is going to be cut, whose ox is going to be gored. We all understand, I am sure, on this committee and elsewhere that you cannot invest unless you save, and you cannot save and consume at the same time.

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[1] See p. 301.

So if you are going to get at this longer term problem, we are going to have to look at this spending, consumption, investment side of our economic equation in America.

I think there is virtual unanimity across America that these unprecedentedly high real interest rates are both a principal source and a reflection of both the short-term economic and long-term economic problem.

We think there is widespread understanding, certainly the financial markets are continuing to send that message, that a principal cause of these high real interest rates are these outlandishly large structural deficits in outyears and that if we permit these to happen, it will destructively divert too much of an already limited savings pool.

Now, we think the problem, to state it simply, is how do we reconcile the obvious need to do something about the short-term economic crisis but to have that consistent with also facing this very profound long-term economic predicament.

SIGNAL MUST BE SENT

What we believe is needed, Mr. Chairman, is some kind of persuasive, unambiguous signal to the financial markets that hopefully you could deliver soon that tells the financial markets that the underlying causes of these outyear deficits, 1985 and beyond, are being attacked, but very important that you send the signal soon but that you not take actions that go into effect immediately and thereby exacerbate the very recession that we have.

Now, why do we think this signal must be sent soon? If we don't, we think we take a serious risk that any recovery that we all so despearately want will be tepid and temporary. It will be very unbalanced and that it will tend to break down when the clashing forces of private capital needs and the enormous, ravenous Federal Government borrowing needs clash which is inevitable at some stage in the recovery, leading once again to destructively high interest rates.

On the other hand, if there is such a signal that we are really going to do something about these long-term structural deficits, we think this should bring a balanced recovery in two or three ways.

First, in the interest-sensitive industries, autos, housing, construction—I was talking with Senator Riegle about the accepted fact in industry after industry starting with autos that interest rates below 10 percent, I believe is Mr. Iacocca's position, would make a profound difference in the demand for automobiles. I need not bore you with what would happen in other industries that are interest sensitive.

We think it is very important if we could get the interest rates down that we could fortify our weakened, crushed, we would say, anemic export industries, a very important point, Mr. Chairman, that has perhaps not received its adequate emphasis.

We believe that one of the serious aspects of these high interest rates is the dollar that on a trade competitive basis is very seriously overvalued. If you look at the drop in the real GNP between the first quarter of 1981 and the third quarter of 1982, two-thirds to three-fourths of that is associated with our net trade position.

Many people believe that we have lost 1 to 2 million jobs, and we believe that the overvalued dollar is an important source of that problem which, in turn, is related to these high real interest rates.

Clearly, we are getting very little investment. It is going the wrong way. Lower interest rates would clearly help that, and whatever we do, we must avoid another exacerbated, we say, unfortunate, unnecessary catch-22 collision between tight money and loose fiscal policy or a catch-22 collusion long term in which we have both long-term loose money policy and long-term loose fiscal policy.

We simply have got to get our fiscal house in order if we are to achieve a healthy balance between fiscal policy and monetary policy.

FISCAL TRIAD REQUIRED TO BUILD FISCAL STRUCTURE

Now, in our judgment, as you know, if we are going to do that to build a fiscal structure, we see a rapidly growing consensus that it will require a kind of fiscal triad. As we point out in charts, there is no way that we can see that significant reductions do not need to be made in defense, in the nondefense areas principally the entitlement programs and interest which is roughly 80 percent of the budget.

We have a goal of $60 billion in nondefense programs focusing on the vast 100 percent indexed, nonmeans tested entitlement programs and subsidies and programs that do not go to the poor.

If we have time, we would like to remind you of the simple arithmetic of what the pattern of budget cuts have been so far. Our analysis of it indicates that the means tested programs that go to the poor have been cut substantially more than the programs that do not go to the poor. Simple equity, we believe, requires us to have fairer burden sharing. Simple arithmetic gets us to the same place.

If you will look at our analysis in the charts, you will find that in 1985, for example, the nonmeans tested programs are nearly five times larger than the means tested programs and have been touched far less.

This is my personal view, I might add, but I would hope that as you look at those relatively small additional dollar reductions in some of the means tested programs that have been proposed in the President's budget—I am talking about numbers like $1 billion each in food stamps and AFDC, $450 million in emergency assistance in energy, $850 million in medicaid.

SHARE THE BURDEN

I, at least, am driven to the conclusion that in relation to a $250 billion deficit, as I look to the need to build a bipartisan consensus for what you are doing which, in my view, requires that the country have a sense that the burden sharing is fair, that you will show unusual diligence and sensitivity in looking at the additional proposed reductions that are targeted to the poor.

I believe a message that must be sent to the American people is that those of us in the middle and upper income groups are now ready to demonstrate that we are ready to step up to the plate, and clearly, it is the poor that have been the principal victims of this economic malaise.

And I think, as Pogo would have said, the principal fiscal enemy is us, those of us in the middle and upper income groups and organizations who are the principal beneficiaries of the most rapidly growing programs.

There is a lot of talk about safety net for the needy. In fact, we think as we look at the untouched parts of the budget, it is more like a well padded hammock for the middle and upper income groups. These must now be the focus of the spending reduction effort.

On defense, as you know, we propose a substantially larger defense cut than the President has proposed, $25 billion in addition to whatever you get in the military pensions. I will not go through all the reasons, but I will remind you that we have several Secretaries of Defense, and Mr. Fowler, Mr. Dillon, Mr. Connally, our founding members, were founders of the Committee on the Present Danger. I do not think anyone has accused them of excessive doviness, if there is such a word.

I think there is a consensus in America for a sustained defense buildup but it is our view that a reduction of the type we talk about will still permit that. It is very important, we believe, that the Soviet Union and, indeed, our allies perceive that whatever you do on the defense budget can be sustained both economically and politically. Ups and downs, feast and famine we do not believe is the right way to negotiate with them.

Chairman DOMENICI. Could I ask you two questions? Your military reduction, is that an additional $25 billion over the salary savings? Is that in outlays or budget authority?

Mr. PETERSON. That is 1985 outlays.

SOCIAL SECURITY IN NONPOVERTY PROGRAM

Chairman DOMENICI. One other question. You categorized the two kinds of programs: the means-tested programs for our poor people and the others that you said, for middle income and higher. Which do you put social security in?

Mr. PETERSON. My nonmeans-tested we mean those programs in which income is not a principal criterion. That would be social security, medicare, military pensions, Federal service pensions, veteran benefits, railroad retirement pensions and so forth. The means-tested would obviously be Medicaid, food stamps, AFDC, programs in which the income of the recipient is an important criterion in whatever is done for those people.

Chairman DOMENICI. I understand the distinction, but I just want to make sure that we all understand the largest of the nonmeans-tested is social security.

Mr. PETERSON. That's right.

On defense also we feel that if we have understood anything about the political vectors in America, we do not see how we can ever politically or ethically for that matter, get indispensable reductions in these nonmeans-tested programs unless defense shares meaningfully in the effort.

SIGNIFICANT TAX INCREASES WILL BE NECESSARY

Finally, we think there is consensus, Mr. Chairman, that as melancholy as an observation as it is that significant tax increases will be necessary, not now when they would be counterproductive in the midst of a recession, but enacted soon so they would be put in place in the context of a growing economy.

We believe the financial markets and we, I would say Joe and Doug, believe that the country has concluded, once again, that it is a lot easier to cut taxes than it is to cut spending. If as a democracy we agree that certain national priorities require us to spend a certain level of resources, then I think we would argue why do we not pay for it directly and honestly instead of borrowing it.

This country is rich enough to afford the Government that we decide we need.

We believe that a form of taxation which again can be done in such a way to protect the poor. It should also be one that favors savings and investment. We can demonstrate, if you wish, that ours is the most proborrowing, proconsumption and antisavings, anti-investment tax system in the industrial world.

OVERALL APPRAISAL OF PRESIDENT'S BUDGET

Against this framework, Mr. Chairman, you might imagine what we would say about the President's budget. We certainly praise his new fiscal realism. When we were founded last spring, one of our deepest concerns was that there was not agreement about the magnitude of the problem. We, I think, now find that there is bipartisan understanding of that.

We would certainly praise the focus on the nonmeans-tested entitlement programs, Federal and military pensions. We believe also, however, that in addition to a freeze, until and unless something is done about the indexing process that has driven these programs, we will not have the kind of fiscal reform that is required.

We would certainly praise the focus on medicare and the perverse and negative incentives that are driving up the cost of these programs. I need not tell a group as sophisticated as this one. Senator Moynihan certainly understands, all of you do, that of the outyear social security deficits, something approaching three-fourths of those deficits are associated with medicare. Of course, the commission did not deal with that problem as part of its charter, but there is not any question as we can demonstrate that those costs are going up dramatically.

We would praise the new emphasis on science, education, research and development, and we can discuss science, education as much as you wish, but it is my view that it is a key to our long-term future.

We would praise commitment to the expanding trade.

SOME CONCERNS ABOUT BUDGET

Our concerns, however—and there are concerns that remain—we believe the deficits are still too big for too long, and we have charts here that will show how much larger they are for a longer period of time than we think is acceptable.

We think, Mr. Chairman, that since the President's message, there may be a message from the financial markets. I asked our principal bond trader today what has happened since the President's state of the Union message, to interest rates. Thirty-year treasuries before the message were 10.75 percent. They are a touch over 11 percent now. Ninety-day T-bills were 7.85 percent. They are 8.25 percent now. They have gone up 30 to 40 points, basis points that is.

I asked our top bond trader why. There are obviously a number of factors. One of them is just what I mentioned. The market has concluded that these deficits are too big and for too long. It is troublesome to see them go up next year even.

There is some doubt, frankly, Mr. Chairman, about the process and whether even this would be accomplished. There was a certain amount of alarm over the size of the net new Federal borrowing that you know was considerably larger than many expected, and frankly, the contingent tax increase is viewed, I believe, in the financial markets as (a) something that is unlikely to happen and (b) that it is subject to enough variables and varying interpretations and triggers, spending cuts, levels of growth, deficit amounts and so forth that it does not have the kind of specificity and lack of ambiguity that we think is required.

Now, I know you have to go. We have here the chart materials on all on these points showing why we have set the goals that we have set and what the savings levels are in the United States and why we believe that in the long term if we do not get deficits under 2 percent of the GNP we will not be able to meet our commitments for capital formation that we have suggested.

Again, I know you have to leave, and out of courtesy to you, sir, we will not go through these charts at this point.

Chairman Domenici. We have plenty of Senators that want to participate, and they will stay. I would remind the Senators that around 3:30 p.m. following this panel we do have three additional witnesses that we expected to hear from, and I hope some Senators will stay. The National Association of Manufacturers, the president of the American Business Conference, and a representative of the small business association will follow these witnesses.

Mr. Peterson. Senator, if you would not mind there would be one or two charts, perhaps, that I would like to cover because they are absolutely central to our argument about the need for savings. Would I have your permission to do that?

ASSUMPTION OF SOCIAL SECURITY COMMISSION'S RECOMMENDATIONS

Chairman Domenici. Well, let us do that and let me just ask you one question. You were busy working on your study while the Blue Ribbon Commission was busy working on its social security study. Do you assume the Social Security Commission's recommendations as part of your package or do you go beyond it?

Mr. Peterson. First, Mr. Chairman, in the numbers that we have presented, it's 17A in the material we gave to you.[1] We have done the best job we could with our limited facilities to show what the net effect is of implementing the Social Security Commission's reforms net on the budget deficit.

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[1] See p. 291.

You know, I am sure, that something approaching $170 billion was contributed to the solvency of the system over that period of time. However, some of this were transfers from other funds.

We compute that the net effect on the budget over that entire period is about $95 billion. You will notice that quite a bit of it is in 1988 and 1989, and the net effect in 1985 is about $7½ billion as we calculate it.

Now, $7½ billion on a base of $250 billion for a program that is about 27 percent of the total, particularly if we take the position that we cannot do much about defense leaves us, we think, in an awkward position where the reductions elsewhere have to be unduly significant or larger.

Chairman DOMENICI. Would you just quickly tell us where you would restrain the budget and what kind of taxes you would impose and when?

SEND SIGNAL OF PRESUMED GROWTH

Mr. PETERSON. Well, you must keep in mind that we are focusing, Mr. Chairman, on 1985. We think it is urgently important to send a signal soon, not in the context of a recession but in the context of presumed growth.

You will notice I said we did not want to take actions now that would exacerbate the recession so when we talk about tax increases, we are certainly not talking about tax increases in 1983. We are talking about taking action sometime over the next several months that would put them into effect in 1985 clearly so that the market would understand that they were there.

We propose $60 billion of taxes assuming that the spending reductions have been made. As I indicated, we do not have a detailed program for consumption based taxes. Different members have different approaches.

But if I may, could I show you why we believe that that should be the orientation?

What we have done here is to show the private savings of the United States in which we subtract the total savings and then we show what happens to them and we show what was left for investment.

Now, during the 1960's, this country put about 7 percent of its GNP net into investments. During the 1970's, they put about 6 percent net. That was the decade that we didn't do very well in.

Senator EXON. Mr. Chairman, could I ask? I cannot see the chart. Is there a chart in here?

Mr. PETERSON. Yes. Excuse me, Senator Exon. It is chart six.[1]

DO NOT EAT UP SAVINGS POOL

Now, one of the things that concerns us mightly about a $250 billion deficit is to show what is going to happen to investment. You can see that this only leaves you with about 3 percent of the gross national product available for total net new investment. That would be roughly half of what we did in the 1970's which most people believe was inadequate investment.

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[1] See p. 279.

So the main target here is to not eat up a very shallow savings pool that we have in this country with large deficits that are obviously negative savings that come off the top.

We set a 1985 goal of a $75 billion deficit which is at 2 percent of the GNP heading toward balance. That would release about 6.5 percent of the GNP for investment. The President's deficit which, as you know, is $195 billion only permits 4 percent of the GNP for investment or about two-thirds of what we had in the decade that most of us thought was inadequate.

We think it is important that whatever we do on taxes and whatever we do on the total fiscal have a central theme to increase investment during the 1980's. And, we have a very small savings pool in this country as is very easy to demonstrate.

On the taxes, incidentally, a lot of people are concerned about raising taxes. You may recall, Mr. Chairman, that at the time the President presented his program he indicated his goal was to reduce spending and revenues to 19 percent of the gross national product by roughly the beginning of 1985 which would have given us a balanced budget.

You can see here what happened, and this is the growing gap as we would call it. Our revenues, indeed, did come down to 19 percent but the spending instead of coming down to this number went up to 25. So with this gap here and with indexing of the tax system that takes place in 1985, we think revenues are going to be in a much narrower range than they would have been, or roughly 18 to 19 percent.

DEFICIT IS STRUCTURAL

Now, this 6½ percent of GNP deficit is after three growth years, and why we believe that this deficit is structural. As a matter of fact, we have read some of the comments that we can grow our way out of this problem.

We have put the best people to work we can on this subject. I will give you our numbers at least. We asked them to assume inflation rates of 3 to 4 percent, 5 to 6 percent, 6 to 7 percent, and assume 3 straight years of 5 percent real growth; there is nobody that we know that is believing you can do that.

The deficits range in that scenario range from $193 to $236 billion in 1985. One of the reasons we are reluctantly advocating a tax increase when the economy is going again is we do not see any basis for the assumption that we are going to grow our way out of this difficulty. It, indeed, is structural.

This shows what the tax level would be. Even after a tax increase, you can see that it would still be flat where we would not be taking more out of the economy.

This, Mr. Chairman, shows what the situation is on defense. Our proposal still allows a 7-percent real increase in defense and an 11-percent compounded increase in hardware over this period of time.

True, during this seventies period we had even a negative real growth, but this is a substantially higher growth than what we may have seen earlier.

Remember I told you we looked at where the budget has been cut in terms of the GNP. It is clear that is on the means-tested programs, that is, the programs going to the poor. It is the State and local governmnets where there have been cuts both in nominal terms and as a percent of the GNP and, of course, in other Federal operations and subsidies.

PROGRAM DIFFERENT FROM PRESIDENT'S

Now, our program, as you can see, is different from the President's. We want to get the 1985 deficit reduction down by $175 billion. Our program is more here. It is obviously much more on the spending reduction side, and it is considerably more on the tax front. With a deficit reduction of this amount, we think interest costs will come down $30 billion to achieve our goals.

We know this sounds difficult. We know it is difficult, but we really do not believe—I think I speak for my colleagues—that we can wait until 1988 to get deficits down to numbers of that sort.

In terms of other material that we want to show you, there is an aspect, Senator, of the debt that we think we ought to look into here. You all know that the deficit is at unprecedented levels, and there is a lot of talk in America about how large the debt is.

What the financial markets understand—I do not think the American people understand it, but the financial markets understand is while we loudly proclaim $1 trillion official debt behind that is nearly $6 trillion in social security and nearly $1 trillion on Federal and military pensions. These are bills that are going to have to be paid. This is part of that mortgaging that is taking place and one of the reasons that the financial markets are as concerned as they are.

REAL INTEREST RATES

I mentioned real interest rates. I do not know if we appreciate just how high they are by any standard that any of us know anything about. We have forgotten that in this last decade we had negative real interest rates long term, an average of perhaps about zero to 2 percent.

We are now looking at 6- and 7-percent real interest rates which is one of the things that is attracting so much money into this country. It is one of the best financial investments that you can make.

Let me see if we have anything else here that is crucial. There is a lot of talk about budget cuts. We thought we would look at where the actual cuts have been. We showed you where they have been in terms of share. You will notice that in terms of dollar cuts, 1980 versus 1985, the cuts have been to State and local governments in nominal terms, the nominal cuts have also been in other operations and subsidies, but there clearly have not been cuts in those other programs.

And all of you are feeling the pressure now in the States and cities as a result of these cuts in nominal terms and in part serious cuts in real terms.

I guess I should also mention, Senator, that we do not pretend that this is a total economic program. We are fully aware of the fact that there is monetary policy, that there is R&D policy, that there is training and education policies and so forth.

But I think what unifies this group is the feeling that a fundamental that is required is to get our fiscal house in order. I mentioned three or four items. I will quickly go through them.

FEDERAL AND MILITARY PENSIONS

I praised the President for looking at Federal and military pensions. This is a nonmeans-tested program, and in the material that we give you, what we have done is to compute what the pensions are to the Federal employees and for the military employees compared to the private sector in America.

And the first thing we did was to take the top 500 companies and take the top bracket of those companies. The percent of pay that goes into pensions is about 10 percent and part social security.

In Government, Federal Government, it is about 30 percent, nearly 50 percent for the military. We then asked the question. What if we ask the Federal Government to fund its pension the way we require under ERISA, the private companies to fund their pensions, what if we had to fund these pensions, because we talk about comparability of pay. We think it is important to get it on a total basis.

This adds this much as a percent of pay. If you now take the current costs plus the amortized costs, here is what the standard is in industry. Here is what it is in the Federal Government. Here is what it is in the military.

We asked some of our staff people who are donating their time, I am happy to say, how much would that add to the expenditures if we were to fund the Federal and military pensions of the United States the way that we require American corporations to fund pensions under ERISA, and it would add over $100 billion a year to the budget.

Now, the financial markets are aware that those bills are coming due.

WORK ON MEDICARE PROBLEMS

I mentioned the medicare. I am embarrassed here with Senator Moynihan who knows a lot more about this than I do, but, Senator, I guess we all know what has been happening there.

Here is the growth in medicare in the last 10 years in total disbursements with a very small growth relatively speaking, Senator Moynihan, in the number of beneficiaries. You can see that the disbursements per beneficiary have shot up dramatically.

Now, the question obviously is if this is what is happening without growth in recipients what happens when we have a growth in recipients that looks like this?

The rhetoric at the Social Security Commission I find is a little perverse. It is optimistic if you have a lot of babies and people die sooner, and it is pessimistic if they live longer and you do not have babies.

But the point is that whether you take the optimistic or the pessimistic projection, we are looking at a period out there 40 or 50 years from now where the number of elderly will be as high as three times as many as we have now.

So when we praise the administration's proposal for their focus on medicare, without commenting on all their proposals, we think it is urgently important that we get to work on medicare problems.

U.S. GOVERNMENT PLAYING DOMINANT ROLE IN BORROWING

You heard a lot about crowding out in financial market and so forth. I do not know if you have ever seen the numbers on what a dominant role the Federal Government is now playing in the borrowing of the United States.

Net new borrowing last year, $202 billion for the Federal Government, $54 billion for the States, only $36 billion in the corporate sector. The concern, of course, is in every recession before long this private sector starts bouncing up quite significantly, and when this starts clashing with this Government number, not at $202 billion but at some larger number than this, we are all concerned that the interest rates start going up and we abort the recovery.

I think, Senator, that is probably a very quick capsule of some of our proposals.

Chairman DOMENICI. Do you have a summary chart as to how you get your 1985 savings, just what they are?

Mr. PETERSON. Well, let us start with the defense area and tell you how we did not do it.

Chairman DOMENICI. I am not worried about that. Get the other bunch.

Mr. PETERSON. Well, on the defense part first I should just indicate that—Joe Fowler may want to talk to that part anyway—we do not have a detailed program of which programs would be cut out. Everybody has got his own programs, but we are all satisfied we can get $25 billion out of this program.

You are referring to the nondefense areas?

Chairman DOMENICI. Yes, sir.

Mr. PETERSON. Well, you will recall or perhaps I did not show this to you that we have a program on the nondefense area as follows.

A 1-year freeze on the cost-of-living adjustments for major entitlement programs. You, Senator Domenici and you, Senator Hollings, will recognize that approach.

Chairman DOMENICI. That includes social security?

Mr. PETERSON. And perhaps others will remember. Part of the rationale for this freeze, Mr. Chairman, is that if you look at the indexing over the last 3 years or so and you look at the actual increase in the cost of living, as we think is better reflected, it is probably about 10 percent overstated so there is some equity aspect in doing a freeze.

In all of these programs, Mr. Chairman, we believe that if there is a will, you can handle this in such a way that you truly take care of the poor. That is, it is not necessary for these provisions to apply to the poor.

INDEXING MUST BE CAPPED

Now, I have heard the arguments, but we are satisfied that you can and must set up mechanisms to protect the poor. We believe that you must also cap indexing after because we do not see any way of getting these entitlements under control unless something happens to the indexing.

We have a variety of proposals. You might be interested in the basis for the 60 percent of the CPI. I am told in Washington, Mr. Chairman, that 100-percent indexing is thoroughly understood in America and the voter understands it and that it is inviolate.

The only data I have seen on this subject was done by the Gallop poll. They asked a cross section of Americans what they knew about indexing. I was impressed with how many of them did not know very much about indexing. I was impressed that a lot of them did not even know there was automatic indexing.

I was impressed that the majority of Americans did not think there should be automatic indexing, and when they were asked what kind of indexing, they thought (a) it should be done year to year, depending upon our ability to pay, and (b) that it should not go up, if it is going to be automatic, any more than the escalators in the labor contracts on the grounds that those workers are the people that are contributing.

We think indexing caps are a very important part of getting budgetary constraint. There are other programs that you are as well aware as I am that do not go to the needed, subsidy programs, and transfers of various sorts.

The key here is that we protect the citizens truly in need. Now, we can submit to you 10 different ways of doing this, but we think that there is that kind of money there. It will be tough but we think it can be done if we decide to do it.

Chairman **Domenici**. Well, almost every one of the suggestions you have made has been suggested from time to time in this committee by one or more of the members of the committee, including a permanent change in CPI.

We did not get it in the social security reform, and it is perhaps available elsewhere. It seems to me we would have a great deal of difficulty changing the CPI for everybody else.

But we have seen those suggestions and they are the kinds of things that were part of Senator Hollings freeze and a part of a proposal I made before. CPI minus 2 or 3 comes out very much like what you are talking about.

Mr. **Peterson**. Right, in excess of 3.

Chairman **Domenici**. Senator Kassebaum will be your chairperson.

Senator **Kassebaum**. Does the panel have anything else?

STATEMENT OF DOUGLAS DILLON, CHAIRMAN, UNITED STATES & FOREIGN SECURITY CORP. AND FORMER SECRETARY OF THE DEPARTMENTS OF THE TREASURY AND STATE

Mr. Dillon. I am Douglas Dillon. I have no prepared statement but I wanted to emphasize that I am in solid agreement with the findings——

Mr. Peterson. Let me interrupt and say he is also on his honeymoon which I think is adequate excuse for his not having a statement. [Laughter.]

Mr. Dillon. That is true, too. I think we all are in agreement that the most important thing that has to be done now is to get the American economy moving again and to keep it moving ahead on a substantial basis.

I am absolutely convinced that deficits of the size that are projected, which automatically carry with them continued high interest rates, will sooner or later abort any recovery that is now beginning, and I think there are some very real signs of recovery now.

So I just wanted to reiterate my complete support of this program.

Senator Kassebaum. Mr. Fowler?

STATEMENT OF HENRY FOWLER, CHAIRMAN, GOLDMAN SACHS, AND FORMER SECRETARY OF THE TREASURY

Mr. Fowler. Madam Chairman, I am Henry Fowler. I would like to associate myself with the views that have been expressed by Mr. Peterson here today and by Secretary Dillon.

I think the most significant line to me of many significant lines in the President's state of the Union message was the one in which he said the deficit problem is a clear and present danger to the basic health of the Republic.

Now, those words in the President's message, in my view, must be reflected by decisive action in this Congress on the time scale that Mr. Peterson has outlined, looking into the outyears ahead if that danger, clear and present, is going to be removed. That danger is a time bomb on the ability of the private sector to maintain, as Secretary Dillon has indicated, a sustained rate of growth over a substantial period of time.

You can jazz up this economy and you can stimulate it for a brief period of time by more spending. You can ignore the problem of deficits and put it to one side by saying, well, we will only worry about the recovery.

But that recovery will tail off and fail just as sure as death and taxes if we do not over time correct the built-indeficit. It has already done it twice in the last decade. I do not know how many more times we have to go through this process to find out that a double digit inflation with a rapidly growing pattern of deficits which relate one to the other will throw this economy into a recession.

RETURN TO NONINFLATIONARY GROWTH

And therefore, I would hope that the decisive action that is undertaken would be on a bipartisan basis, so that the action taken will give the assurance and the signal to the private sector that this corrective pattern of fiscal policy is not a brief and passing phenomenon but something that is going to be sustained over the time period necessary to bring us back to a relatively healthy state of noninflationary growth.

Now, some people will say that there is not any such thing as an noninflationary growth. Well, there is noninflationary growth, and if you look at your statistics, you will find that a greater part of this postwar period was characterized by a very healthy rate of relatively noninflationary growth that created jobs, that reduced unemployment to relatively minimal levels, that invited increased investment, that made this a healthy and strong country and that it is only in the past decade that we have substantially strayed away from it.

Now, I say these things, members of the committee, with a good deal of humility and a certain amount of recollection because I know what this committee is up against. I know that when I was Secretary of the Treasury in the late 1960's, if there had been a committee of this sort, I do not know what a price I would have paid for it. It provides a place where you could come and expect to have a pattern laid for the Senate for a responsible fiscal policy instead of having the authority divided and scattered between committees and subcommittees on this and subcommittees on that. I bear scars, as I said to several of the members before, from the awful ordeal of 1967 and 1968 when we could see a pattern of inflation emerging in the longer term future but had no single responsible legislative committee to turn to the budget.

And we saw the deficit go from a few billion dollars to $8 billion in 1 year, and then we came in with a program to try and deal with the problem and it took 11 months to get it enacted.

In the meantime, we were in another fiscal year beginning over July 1, 1967 to June 30, 1968, and that deficit was $25 billion. But by a bipartisan action, and I do not want to name names, but by Members in the Senate on both sides of the aisle collecting together, the Senate took action to provide an increase in revenue and to reduce substantially the spending in the nondefense areas of the budget which produced a surplus in the budget for the fiscal year beginning July 1, 1968, and going to June 30, 1969.

So it can be done. With this committee having come into being and taking the role that it has under the act, I would hope that it could set the corrective pattern and give a signal to the private sector that we have recaptured control of our financial and fiscal destinies and it is time to begin to invest and make plans over the longer terms.

Senator **Kassebaum**. Thank you. I think we would all join together in saying that this bipartisan commission has done an enormous service in assisting with the budget debate and the contribution is greatly appreciated not only here by this budget committee but I think around the country.

Senator Hollings said to me before the hearing began, let us get bipartisan, and I certainly do think that it is important. Sometimes it is easier said than done.

And I would just like to ask for a first question briefly, if I might, you mention wanting to find $60 billion in revenue in 1985. I do not believe you spell out exactly how this would be done.

Do you assume that the third year of the tax cut would not go into effect?

Mr. PETERSON. No.

Senator KASSEBAUM. Or do you make any particular assumptions there?

CONSUMPTION-BASED TAXES SUGGESTED

Mr. PETERSON. Senator, our focus on the 1985 taxes would be consumption-based taxes. If we had time to do it, and I will be glad to send it to you, Secretary Fowler and I and others have looked at the tax systems in the United States versus the rest of the world, because we tend to assume sometimes that the reason, for example, the Japanese save more is that it is some cultural, intangible, qualitative factor.

If you study carefully their tax system, you will find very profound differences, and that is clearly one of the explanations.

Now, it seems to us that you will have to decide in your good wisdom whether you agree with our formulation that for us to get this economy moving again and to get productivity up, we are going to have to do a lot more investment.

And if you do that and you acknowledge what we are saying that these huge deficits are negative savings—they come right out of the savings pool—then we think it is very important that whatever you do on the tax side does not further reduce an already-shallow savings pool that is more appropriately called a puddle I would think.

And therefore, we would like to see the taxes be in the consumption area. Now, to be very candid with you, when you are talking about 500 Americans of various points of view you in the Senate know how difficult that is to get a precise tax program.

There are at least 10 different consumption-based taxes that have been suggested. We do not get involved in the particular form of the consumption-based tax but we urge upon you to consider that kind of tax, again, a tax, however, that is so structured that it protects the poor.

Senator KASSEBAUM. Senator Hollings?

Senator HOLLINGS. Thank you, Madam Chairman. I always think bipartisan when I see you. [Laughter.]

Let me say this, Mr. Fowler, and to all three of you, that it is significant and dramatic that you would come. We must be in real economic trouble. I believe it. And for you to work over the entire part of last year, Mr. Peterson, to get the colleagues together was not an easy task. I congratulate you and your willingness to come here and I hope you will follow through and not just work on us but also work on the executive branch.

REAL GROWTH WAS HAD WITH INCREASE IN TAXES

I say that advisedly. Mr. Fowler, when you talked about getting together, I was here when we did that on a bipartisan fashion and balanced that budget 1968–1969. We had an increase in taxes, and we had real growth, incidentally.

I got on the chain of Bisnet program and the fellow just was amazed. He said, "Have you ever heard of increasing taxes and having real growth?" I said, "We did it in 1968-1969, left this Government a surplus and had real growth, 1969, 1970, 1971. We sure did."

They did not think of that. Similarly with respect to President Carter, we had that feel of a discipline and pressure. I went to the President as chairman of this budget committee and said, "You are going to leave a bigger deficit than what you inherited from President Ford." And he said, "Well, what can we do?"

And we got together on a reconciliation or spending cut with a lameduck Democratic President and a lameduck Democratic Congress in December 1980, and we cut. And we left a smaller deficit, $59.7 billion.

Now, just at the time we thought we got the business community, the Congress, Senator Kassebaum, Senator Boschwitz, and others on that side and Members on this side, together and ready to do our duty, the President did not set that scene for us.

He did not set a bipartisan approach. He set a very partisan one in the context that he comes right out and says, "Now, wait a minute. I am going to get my increases in defense," and start playing games with the defense figures.

Tomorrow morning we will have the Secretary of Defense here and I will put him on notice this afternoon ahead of time. He is asking anywhere from a $36 to $40 billion increase, not any kind of freeze or holding down the line.

And the President said you are not going to touch that area, and you are not going to touch my tax cut for July. And after I have gotten those two programs now let us get bipartisan on yours, on your spending programs.

BIPARTISANSHIP NEEDED

And that just does not really set the pattern for us to get together. I am worried about this committee. I think they can do it again if they do like they did last year and stonewall and go right down the party line. But even if they do that, I cannot see a resolution passing on the floor unless we can have what you are really pleading for and demonstrating here this afternoon, namely, bipartisanship.

And with the limited time on questions, let me raise a point relative to the third-year increment of the tax cut because the budget program brags openly that there are reduced revenues as a result of the Reaganomics program of more than $1 trillion over 1984 to 1988.

I would amend the presentation. I don't agree with the slide. I do not think we just slipped into this. I think we jumped in foursquare. I mean there was not any slide. We intentionally went.

We did not do what Secretary Dillon did. He put in business taxes for business only. Supply side for business only, and it was 2 years later under Secretary Fowler in 1964 that we put in the demand side. So we tried to do too much 2 years ago and we did it intentionally.

We brag about it right now. You are losing a trillion in revenues. What about that 30? Why can't we go after that rather than go through with user taxes that again hit cigarettes and again hit gas.

You know the realism of the National Congress and with an election year coming up again next year, no one is going to be voting for increasing taxes.

But we could get a bipartisan move to stop that revenue hemorrhage by eliminating this July increment and perhaps doing away with indexing. And we would do more than trying to pick, pick away at gas, tobacco, and oil.

THIRD-YEAR INCREMENT ENDORSED

Mr. Fowler, what do you think about that third year increment? I get that you folks unanimously endorsed it so long as you went along with the freeze of a year on the entitlements, is that right?

Mr. FOWLER. Yes, we did go along with the freeze. I think you will find in the advertisement that the 500 people supported the statement on taxes that revenues should be increased, and I quote it:

> * * * be increased by about $60 billion in fiscal 1985. The principal source of these increases in revenues should be from consumption-based taxes and by imposing user fees on the government's commercially valuable services.
>
> Modifying, delaying, or stretching out the income tax cut for 1983 has the unanimous approval of the undersigned members only in the context of a prior agreement on the kind and magnitude of spending cuts referred to in parts 1 and 2 of this program. These steps if undertaken now would cut * * *

Well, that refers to the three areas.

So we feel that basically our preference is, as Mr. Peterson has outlined, to use this opportunity where it is needed for the budget deficit to reorient our tax system a little bit—it could be fairly significant in terms of a signal—to the consumption area, to the so-called value added type of tax or consumption tax which all of our trading competitors, particularly those in Western Europe, commonly employ.

They do it for various reasons, and in my own view, one of the reasons they do it is that it is an intangible but a very real advantage to them in building their export markets and competing abroad, because as those goods are shipped out of their particular country, they do not pay the value added tax.

If we ship goods into those countries, we have to pay the value added tax. They are border taxes basically. So we think that some movement in our system to provide this $60 billion of revenue ought not be addressed to the income tax sector of the budget which is the area which conditions the savings, the personal savings as well as the business savings.

And therefore, our preference would be, we think it would be best for the country in the long pull if the focus for this additional revenue would be in the consumption area.

Mr. PETERSON. Senator, I might add if I could, that I will be glad to send you a little study we have done of the taxes in the seven major industrial countries of the world and what proportion of the revenues they received are relatively biased against the productive production side and what percentage are biased against consumption.

But I am not sure we appreciate how biased our system is. For example, of the United States, Canada, the United Kingdom, Japan, West Germany, Italy, and France, we only have about 40 to 42 percent of our taxes that are biased against consumption.

Some of these other countries have 60, 71, 75 percent. The reverse of that is on investment. And I will be glad to send this to you, but there is a reason these other countries are saving more.

Senator **Biden**. Would you send that to all of us?

Senator **Hollings**. Let us make it a part of the record.[1] And also add there that the last gentleman that mentioned this seriously around here was one of the best of the best, Al Ullman. They left him in Oregon. I wish I could elaborate. That ought to go in there.

I mean, you know what happens. You talk about the fairness and the means-tested programs and everything else. They say that a national sales tax falls more heavily upon consumers and the poor and therein is your difficulty.

Senator **Kassebaum**. It will be made a part of the record.

It beats me how we could get $60 billion in the consumption tax in 1985 realistically. I think it should be a part of the record, those figures. I think it would be a very interesting part of the record.

How we question here in this committee is in order of arrival. Senator Boschwitz, is he here?

Senator Gorton?

TOTAL SPENDING CUTS

Senator **Gorton**. I would like to follow up on the question of Senator Hollings. When you speak of $60 billion of revenue in 1985, is that a figure designed to be roughly equal to the spending cuts in 1985?

Mr. **Peterson**. Senator, if I can find it in this pile, we started out with the premise that we did not want to rob investment for the future. We looked at the savings pool, and said how big can that deficit be.

We concluded that it cannot be any bigger than 2 percent, or you are just not going to have enough left for investment. Now, 2 percent of the GNP is about, in 1985, is about $75 billion.

So what we did, sir, is we said the deficit should not be larger than 2 percent, the economy would be about $3.8 trillion to $3.9 trillion in 1985. That is about $75 billion. We said spending reductions come first, because we have got to release the resources to the private sector.

We went as far as we thought anybody could reasonably go, and further than a lot of people think you can go, which was $60 billion and $25 billion for a total of $85 billion.

We are dead serious, though, about telling those financial markets that we are going to get the deficit down. So with the spending of $60 billion and $25 billion in defense in 1985 and with the $30 billion from the interest savings, what we end up with here is a goal of $175 billion reduction, counting the $60 billion increase.

Now, if you are going to get $60 billion out of nondefense, $25 billion out of defense, $30 billion out of interest savings, that leaves

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[1] Not received at time of printing.

$60 billion in there which you got to get somewhere else, and we believe that it should be consumption-oriented taxes.

So we arrived at that number painfully because we do not like tax increases, but after going as far as we could on the spending side which we assumed was the number one priority.

FORM OF TAX IS DECISIVE

Senator GORTON. But I take it that you believe that while a deficit is a deficit, the way in which you reduce it also has an impact on economic growth, and you cannot just say that it does not matter whether it is spending cuts or tax increases or for even that matter what kind of tax increases.

Mr. PETERSON. Senator, in our opinion, it makes an enormous difference because if all you do on the form of your tax cut is to reduce these savings up in here, all you are doing is reducing the savings pool and you still do not have the bottom line that we are after, which is net amounts left for investment.

So the form of the tax is decisive in our view if you are going to achieve the net investment goal.

Senator GORTON. If, obviously, as is the case with anything we do here of this nature, each of these decisions is a painful decision where someone must pay as a result of it, did you assume that if we follow your prescription that the rate of growth in the economy will be greater than it would be if we simply were to adopt the President's budget or for that matter do nothing at all?

Mr. PETERSON. Well, our assumptions of growth were 3 to 4 percent in real terms over this period of time. We think that is a reasonable assumption to make.

Senator GORTON. Do you know? Can you state for the record how much that differs from the projections of growth in the President's budget?

Mr. PETERSON. No, I am sorry. We believe that the current budget that has been presented is a fiscally realistic budget both on the deficit side and the growth side. What concerns us, frankly, is that deficits of that magnitude, once the recovery starts going and the private capital starts competing with the Government, borrowing needs will send interest rates up and will abort that recovery and bring the growth rate down again.

Senator GORTON. Now, you got to be saying one of two things though, Mr. Peterson, and I would really like to know which one.

Mr. PETERSON. Well, I often say more than that.

Senator GORTON. Either you are saying that the projected deficits in the President's budget are not consistent with the rate of growth he projects——

Senator BIDEN. Which is 3.9 percent. For the benefit of our witnesses, he is projecting 3.9 percent with the budget as submitted.

Senator GORTON. Correct. Either you are saying we cannot have that high a growth rate with the very large deficits in the President's budget or I assume alternatively that if we can have that kind of growth rate with the President's deficits, we would presumably have a significantly higher growth rate if we reduce them in the fashion that you outline. I would really like to know which of those two you believe to be the case.

Mr. PETERSON. Senator, I think that is a very perceptive question. We have not even counted votes among the 6 of us, let alone the 500. I think I speak for my three colleagues here that if we had to guess, and is this an accurate statement?—if we permit the deficits to be this high and long about what, Joe?—next June to September to somewhere in that period, the last half of 1983 the growth in private credit starts coming up, and if you will forgive the expression, what Goldman, Sachs calls the financial time bomb hits us, my guess, Joe, would be that the subsequent projections of 3 straight years of 4 percent in real terms, isn't realistic, isn't that about it?

Senator BIDEN. Yes.

Mr. PETERSON. After the first year, may be hard to achieve in that context.

Mr. FOWLER. I would say forget it for the next 3 or 4 years because sooner or later this collision we're going to talk about is going to cause the growth patterns to abort.

INVESTMENT AND GROWTH HAVE STRONG CORRELATION

Senator GORTON. Can we summarize by saying that the lower the deficits, the higher the rate of real growth in the economy?

Mr. FOWLER. I would put it this way. The higher the deficits the less likely you are to achieve what would be a healthy financial fiscal policy and a quite achievable sustained growth of 3.5, 4.5 to 5 percent.

But if you are going to do it according to the existing pattern, you are going to go over the cliff as we already have done twice in the 1970's. So the sustaining character of the growth that you are going to achieve, which is necessary, you will not achieve unless you do something effective about these deficits.

Mr. PETERSON. Senator Gorton, I think your question is an extremely important one, and I would like to come back to this chart that we think is central. If you look at growth of the industrial countries for the last 10 to 20 years and plot on one axis the investment and productivity-enhancing activities, capital and labor ratios, et cetera, and you plot growth on the other axis over a period of 10 to 20 years, you will find that there is a very strong correlation between how much you invest in your future and how much you grow.

What concerns this group which was founded by the six of us around the concept of the long-term health of this country, not the short-term but the long-term health, is that if we start permitting this kind of deficit in 1985, we are saying only a net 4 percent of GNP is available for investment.

Roughly half of that typically goes into housing, as you know, in the United States, leaving only 2 percent net for the business sector. Now, I do not want to keep talking about the Japanese but remember that number.

They spent 9.8 percent of their GNP net just on new plants and equipment in the 1970's so that I think—long term—permitting these kinds of deficits means even less investment, means even less growth in the future.

Senator **GORTON**. I thank you and I thank you, Madam Chairman.

Senator **KASSEBAUM**. Senator Chiles.?

Senator **CHILES**. I will pass.

Senator **KASSEBAUM**. Senator Exon? I am sorry. According to the lineup, Senator Riegle is next.

Senator **RIEGLE**. I was out of the room. Perhaps Senator Exon would go next. I would be happy to follow him.

Senator **EXON**. Thank you, Madam Chairman.

I want to join my colleagues in appreciation for your coming here today. I have been following with keen interest the statement that you have been making. I have been one Member of the Senate that has supported, I guess, about every vote that we have had with regard to a freeze, notably Senator Hollings efforts in this regard.

Last spring I opened debate on the first concurrent budget resolution and outlined at that time the staggering deficits that are even higher than I and CBO estimated at that time.

I am quite surprised at some of the statements that I hear today by some people who should be more knowledgeable who are suddenly surprised at what has happened at this particular juncture.

I do not know that I agree with all of your conclusions but I salute you because there have been many of us who have been sounding the similar alarms that you have, but we do not hold the distinguished position that you people have held, and therefore, I salute you for beginning hopefully to convince the people of America that we have to deal with our constituents when we try and do some of the things—at least to some degree—the way you are recommending.

Some of the things, though, do confuse me a little bit, and that is this. With the picture that you are painting, Mr. Peterson, that you indicated in your opening remarks with regard to the increase in T-bills and the further downward trend in bonds, what is the reason for the bull market on the stock market?

Are they fooled or is that just a short-term projection?

BOTTOM-BOTTOM THEORY

Mr. **PETERSON**. My trying to explain the stock market exceeds my depth, but I will tell you what I have heard. There is an interesting theory, Senator Exon, on Wall Street that is called the bottom-bottom theory, and what investors try to do is to pick the bottom because obviously after the bottom comes a rise.

And along about the tail end of last summer, Joe and Doug, I think a number of people decided that we were hitting bottom. One of our investment managers has 25 criteria of the bottom, and without getting morbid about it, one of them was that there needs to be a suicide in the brokerage business as one indication that things are not doing well. [Laughter.]

Well, this person felt and so argued one day that the test had been met, that test had been met in Milwaukee, I believe, or somewhere.

To be a little more serious about it, the feeling was, Senator, that the economy had gone so far down that it was going to go up and since the market anticipates the future, they figured that earnings would be going up in American corporations.

Now, the second reason earnings would be going up is not growth alone but I believe Goldman Sachs has done a very interesting study. I do not know why I am building up their already enormous advantage over the rest of us in this piddling industry but Goldman Sachs has done a study that I think is interesting—that shows how American corporations have reduced their cost structures, you know, in this recession.

So I believe, Joe, the assumption was that even modest growth would bring through an increase in earnings that was disproportionately higher than that, and since the stock market anticipates presumably there was that.

Finally, the drop in interest rates, of course, came with that, and since life is a choice of more or less undesirable or desirable alternatives, as the interest rates came down, it sharpened the stock market's focus on what the alternatives were.

But more recently, as you know, the boom is unboomed or something. The stock market clearly is in a mode that is not clearly up at the moment.

Senator EXON. Thank you. That was very helpful. I could not see the charts very well and had difficulty finding them. Through your projections, assuming that no change is made in what you see as a very threatening situation in 1985, if not sooner, did you have any projections of what the inflation rate would be or would it be level or would we have deflation?

I do not believe you mentioned that. Did you project that anywhere, Mr. Peterson, or either one of your distinguished colleagues?

Mr. PETERSON. Joe, your people have done a lot of studies here.

Mr. FOWLER. Well, I would have to say on inflation, if I may take your question to say I am associated with another group which is called the Committee to Fight Inflation, and I call them the 13 elderly Don Quixotes singing the impossible dream, but it includes some of your former colleagues here, Wilbur Mills, John Bynes, the chairman and ranking minority members of the House Ways and Means Committee; John Williams, who was the ranking Senator on the Republican side in the Finance Committee, and George Mahan, who was the chairman of the House Appropriations Committee, and then some Secretaries of the Treasury during this period, like my colleague Douglas Dillon and Bill Simon and George Schultz, who was on it just before he was elevated out to his present diplomatic post, and Mike Blumenthal, and so forth.

INFLATION NOT JUST A BUDGETARY PROBLEM

Now, that group has a recent report which I will use just if I may to answer your question. In dealing with the problem of inflation, we recognize that it is not just a budgetary problem. There are many other elements in national policy which have an effect on inflation, but dealing with the problem of fiscal policy and the budget is one of the fundamentals that you must deal with if you are going to hope to maintain a declining level of inflation or to hold the level that you have gotten down to for any appreciable period of time.

So in a report issued on January 12, the signatories to that committee, which include now several others to replace those that are gone, said as follows:

Large deficits are,

And I quote,

A normal consequence of recessions which hold down tax receipts and increase unemployment benefit payments and other outlays. Insofar as deficits are induced by recession, they are not necessarily inflationary.

There is,

And this is in special type,

However, no precedent in our history for a stream of enormous deficits long after the end of a recession. The prospect of continuing deficits of the order of 4 and 5 percent of GNP is particularly disturbing because such deficits would absorb the great bulk of private savings which typically runs between 6 and 8 percent of GNP.

With so little saving remaining for use by the private sector, real interest rates would stay abnormally high and the investment needed for growth in production and productivity for jobs in the private sector would be retarded indefinitely.

Then we said about inflation,

Large deficits in nonrecession years would also have important short- and long-run consequences for inflation. In the short run, their inflationary effects could, in principle, be offset by greater monetary restraint,

Tougher Fed policy,

But that would complicate the problems of the Federal Reserve.

Their longer run inflationary impact would arise out of the frustrations of a citizenry with a tradition of rapidly rising living standards that finds itself condemned to a stagnant or slow growth world.

Under such circumstances, there inevitably would be rising pressure for larger slices of the inadequate pie in such forms as demands for bigger increases in money wages, greater protection against imports and expanded restraints on domestic competition, all of which would contribute to inflation.

And then the report goes on to say that clearly we must foster a resumption of substantial and sustained economic growth. For this purpose, we must sharply reduce the size of prospective Federal deficits.

Senator EXON. Thank you. Mr. Chairman, I would like to ask if he would give us a copy of that and that it be incorporated in the record for our reference and thank you.[1] My time is up.

ROOM FOR DISCUSSION ON MONETARY POLICY

Mr. PETERSON. Senator Exon, there is one point, and I do not claim to be a monetary expert, but here is what I am told on this subject. As long as the economy is in a slack position we are in and the demands for money are not very high, many people have room for argument as to what should be done about monetary policy at this time.

I think most economists, however, agree that if you monetize these enormous Federal debts and the economy is also then much closer to capacity and you have what you might call a loose fiscal policy with a loose monetary policy, not today but in the context of growth, that that then sets up an expectation of high interest rates and high inflation which, in itself, brings about that result.

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[1] See p. 325.

So I think there is room for plenty of discussion about what monetary policy should or should not be, you know, at this moment or the next moment, but in the context of longer term growth, to also have monetizing these enormous deficits and also provide enough money for the private sector is a real problem.

My bond trading friends in our establishment tell us that that could lead to an expectation of inflation which could be dangerous not today as in the context of growth.

Chairman DOMENICI. Senator, are you next?

Senator GRASSLEY. Well, I am the only other Republican here so I have got to be next.

Chairman DOMENICI. You may inquire.

Senator GRASSLEY. I am sorry. I did not mean I was the only Republican. I am the only Republican who is not chairman of the committee. [Laughter.]

Chairman DOMENICI. I understood, Senator.

Senator BIDEN. You may be the only Republican.

[Laughter.]

LEVEL OF SAVINGS IS DETERMINING FACTOR

Senator GRASSLEY. Is there any consensus among your group, and if there is no consensus, then I would like to have your point of view, on the percent of the gross national product that the Federal budget should be?

Like right now it is roughly around 24 percent. It has grown 1.5 or 2 percent in the last 2 or 3 years. I ask any of the three of you but I am more interested in whether there is any consensus.

Mr. PETERSON. Senator, I think (a) I don't think there is a formula answer to that, but I would argue and that is why I will send you this material. It is very important to understand what the level of savings are in the economy and what the level of consumption versus investment is in the particular economies.

I notice a lot of people say to me, well, gee, I do not know what you are worried about, Mr. Peterson, you and your financial friend. The Japanese have a 5.5 percent or 6 percent or 4 percent or whatever percentage of GNP in deficit. But the Japanese have a gross savings rate of 36 percent versus our 19 and a net savings rate at the household level that is four or five times ours.

So they can afford these programs and they can afford the deficit and still have plenty of money left over to invest, you see. So to me the answer to that question, and I do not know whether my colleagues agree, depends to some extent on what your level of savings are in the country.

At one level of savings, you can tolerate a deficit. At another level of savings, as we have demonstrated, you use most of your savings to pay off the deficit.

Senator GRASSLEY. I think my question would be just as applicable even if we did not have the large deficits we are facing. The question of whether or not the Federal spending as a percent of the GNP ought to continue to grow as it has been growing.

Mr. FOWLER. I think you have got several things there. Just the increase in the trajectory of the Federal debt which in the light of interest rate problems means an increasing drain on the private sector just to carry the debt.

We see lots of examples around the world today of nations that cannot carry the debt that they have created from, say, external sources as well as internal borrowing in their own markets.

I think that another way of looking at your question or answering your question is that I do not think we as a group have arrived at any feeling about the percentage of GNP because most of us feel that the ideal situation is to get down to equilibrium so there is not any more borrowing.

Indeed, there is a good deal of economic and business support for the notion that it would be desirable for the Federal Government to run a surplus for a while that would add to the pool of savings that would be available because it would be paying off debt and adding to the pool of savings that are out there for the private sector to utilize.

DANGER TO HEALTHY ECONOMY

So I think we probably could find ourselves in a position of saying that anything over a given percentage would carry a clear and present danger to a healthy economy. I do not think any of us, on the other hand, would like to say that it is alright to run 2 percent of GNP as a deficit because I do not think that is a healthy national policy.

Mr. PETERSON. Senator, I am not avoiding your question, but I would remind you of two things that I know you are aware of. Under the way we handle our books in the United States, there are at least two phenomenon that make the numbers require a great deal of scrutiny.

In the first place, as you know, we really do not differentiate between expenditures that are investments and expenditures that are spending items that are consumption items.

Now, one of the things that shocked me when I studied the Japanese economy in the 1970's was that they spent 5 percent of their GNP in the 1970's in infrastructure, mass transportation and highways and so forth, which clearly make their contribution to productivity and so forth.

We spent only 0.7 percent, but the way we keep our books that expenditure that is related to a long-term investment is treated in the same way that an entitlement payment is treated which is nothing more than a consumption item.

The second thing to consider is the point I made about unfunded liabilities. The way we keep our books, we only record the particular disbursement that is made in the particular year, but if this were a corporation or certain other governments which fund some of their programs that funding then of those outyear payments for pensions and so forth becomes part of the savings pool, but we don't have such funding.

But in our way of keeping books, we do not record the contractual liabilities for the future as part of the percent of GNP for spending. You see, I could argue that if you had a more honest, I guess I will use that word, set of books and you really recorded each year what your liabilities were, you would find that your spending is actually higher on those spending programs than it appears to be because those bills are coming due.

Senator GRASSLEY. Could you clear up something for me quickly before my time is up on here because I do not want to take any more time?

It says here that where you are arguing for consumption based taxes, I mean that is what you are arguing for, is it not?

Mr. PETERSON. Yes.

Senator GRASSLEY. Down here there is a caveat where it says modifying or delaying or stretching out the income taxes for 1983 has the announced approval of the undersigned only in the context of prior agreement on the kind and magnitude of spending cuts in part 1 and part 2. OK. Is that applicable to the consumption taxes, too, or do you not have to have the increase in the consumption taxes related to the decrease in spending expenditure?

NO. 1 PRIORITY IS REDUCING SPENDING

Mr. PETERSON. I think most of our group as we say earlier in the add puts the No. 1 priority on reducing spending. That is the No. 1 priority, and I think we generally assume that should come first.

We have also identified what we think are the spending cuts that might be made. We come to the taxes, Senator, last on the hit parade only because we think that is about as far as we can go on spending. That is a very important part of it.

Senator GRASSLEY. The connection between tax increases and the cutting is applicable to the consumption tax as well as to the income tax.

Mr. PETERSON. Yes. I think most of our group would say the top priority should be on spending cuts, right.

Mr. DILLON. I think I can answer your first question maybe more directly. I think that we all agree that the 24 or 25 percent is too high right now, the reason being that we are concerned with the deficit which is 6 percent of GNP which we pointed out is impossible and will bring these high interest rates.

If you are going to reduce that deficit and not cut 24 or 25 percent of expenditure, you are going to have to increase taxes not from 19 percent to 20 percent as we are recommending, but from 19 percent to something like 23 percent, and we certainly do not recommend that.

So therefore, to get a balanced program, I think that we feel that expenditures should be contained so that by 1985 they only are 22 percent or something like that, not 24 or 25, and taxes at 20 percent with the difference of only 2 percent.

Senator GRASSLEY. Thank you, Mr. Chairman.

Chairman DOMENICI. Senator Riegle?

Senator, before you proceed, could I just ask how many more Senators will need time so that the panel will know?

OK. For the next panel, I do not see any other way to do this. We are going to stay here long enough to hear you. We beg your indulgence in terms of waiting. We are going to proceed. These gentlemen will not be back, and everybody came to question them so we will complete it. I hope some of you will stay for the other one.

Senator Riegle?

Senator **Riegle**. Thank you, Mr. Chairman.

First of all, I would like to say that I think this is a very important initiative that you have collaborated on together with the others who are not here, and I very much appreciate the effort that has been made and the care that has gone into it which is obvious both from your testimony and what you have had to say and the charts and the other things.

I think what you are doing here will end up making a difference on the end product so I do not think this is just an exercise that everybody is going through. I think this will have an impact on the margin and I think that is important that it have.

I think there is a lot of sense in what you have said here, too, as well. I may not agree with each and every part, but I think in the main that you are on the right track and on a sounder track by far than the one we are now on.

PRESIDENT NOT SPOKEN WITH

Two things I would like to raise. First, have you had a chance to meet with the President and to lay this out in this kind of detail, and if so, what was the response?

Mr. **Peterson**. We have not had a chance to meet with the President. We have met a number of months ago with Secretary Regan, and I might tell you, Senator Riegle, what we did is a matter of communication. We have nothing to hide. Part of our effort, frankly, is educational, producing studies and letting anybody look at them that wants to look at them.

I think Senator Domenici and Senator Chiles will acknowledge that for the last 6 to 9 months we have been sending you copies every month or so of our work, our studies, our supporters, et cetera.

Within the administration, we have taken all of the senior economic policy officers and we send them everything we do. A number of them, many of them call us and ask us questions. We visited with some of them.

But on your precise question about the President, no, we have not spoken with him.

Senator **Riegle**. Well, may I make this suggestion. We, obviously, wanted you to appear here, and you are here today.

Mr. **Peterson**. And we appreciate it.

Senator **Riegle**. And it has been constructive all the way around. I think the one person you have to meet with in the Reagan administration is Mr. Reagan. I think he is the one in the end, the President, who needs to also consider what you are saying, see what questions it raises in his mind, and I would like to urge you to press hard for that.

I cannot believe that this group cannot get in to see him. I certainly would not want to believe that.

Mr. **Fowler**. We are very shy, Senator, about pressing ourselves for an invitation to the White House.

Senator **Riegle**. Well, let me just say that I think we are at a point where that may be becoming on personal terms but I think maybe the time has come where he needs as well to hear what you have to say, and I wish you would press a little harder and see if you cannot get in the door and discuss these things.

The other thing is this. You know, as I have listened to what you have said—I had to step out for one event that was taking place here, but I heard virtually all of it, and going back to your period, Secretary Fowler, in the late 1960s and I was serving in the House at that time, and I remember those presentations and so forth.

And in many respects the world was different. I mean, there were a lot of different problems. We had the overhang of Vietnam and so forth, but the world economy was different.

DIFFERENTIAL ADVANTAGE HAS DISSIPATED

The thing that strikes me is that there has been an enormous transition since World War II. Japan has really come back from the war and they are an entirely different factor in the world trade picture vis-a-vis our economic system than they have ever been before.

Also true for other emerging countries out in that part of the world but certainly Germany came back from the war and things did change. We had a period there where we had enormous differential advantage, but it has been dissipated in many ways.

And I am getting to the issue of industrial policy and the question of what is going to happen to the smokestack industries, and if we write off 2 or 3 million jobs in that area or more, if you take the whole line of commerce back to the mines and so forth, it is not clear to me exactly where the replacement jobs are going to come from.

People talk about the service industries. It would be terrific if suddenly you could have a one-for-one transfer of people into replacement jobs but that does not seem to be on the horizon as far as I can see into the future.

And what I would like to suggest is this. Having done this job and not being finished with it, my hope would be that with the group now assembled maybe you could take a look at that sort of second level issue as to how the world economy has changed and how we fit into it to see what part of this problem has now to do with shortfalls to the worldwide and the tradeoffs in unemployment country to country that get into exchange rates, get into differential interest rates which are bearing in on this thing quite substantially.

We do not have the body of knowledge here, frankly, in the Congress that is closing in on that problem, and it would be enormously helpful to the country if we could have that as a second phase effort that could sort of fit into what you have done so far. I would just like to urge you to consider doing that if you would.

Mr. Fowler. Thank you very much, Senator.

Chairman Domenici. Senator Boschwitz?

Senator Boschwitz. Am I next?

Chairman Domenici. You are the only Republican left. I was reminded of that awhile ago.

Senator Boschwitz. Thank you very much.

VARIETY OF INDEXING CAPS PROPOSED

I missed part of your presentation and I apologize. I was scheduled for a number of things at once. I would like to ask you to be as specific as possible with respect to nondefense cuts. The note that my staff person gives me is a 1-year freeze on COLA's, entitlements, social security, veterans, and military and civilian and governmental retirement, a cap on indexing thereafter to 60 percent of the CPI, is that correct?

Mr. PETERSON. We propose a variety of indexing caps. One is 60 percent, another one is inflation rate less 3 percent. What we are trying to say, Senator, is that we say arithmetically, fiscally, and I would even argue ethically impossible to control the budgeting mechanism of the United States without doing something about that indexing, particularly if you got a tax system that is indexed.

Senator BOSCHWITZ. Have you put numbers behind all those things? Is that going to achieve your objective?

Mr. PETERSON. What we have done, Senator, while you were gone we mentioned this, each of us has our own package, but to be responsible people, we have seen if we could come up with these numbers, and we believe you can. It will require you to go considerably further than you have now.

Senator BOSCHWITZ. Is this enough to achieve what you want to achieve?

Mr. PETERSON. Yes. Our objective, Senator, is to get the deficit in 1985 down to $75 billion which is less than 2 percent of the GNP which achieves our investment goal. That requires $175 billion, and while you were gone, we mentioned that $60 billion on nondefense, $25 on defense, $30 on interest and $60 on taxes will achieve that goal.

REDUCTION IN MEDICARE COSTS REQUIRED

Senator BOSCHWITZ. I understand that. But a 1-year freeze on COLAs and entitlements and a cap on indexing thereafter, will that be the $60 billion?

Mr. PETERSON. No. That is only part of it. It would require medicare, for example, reduction in medicare costs. It would require doing something about some of the subsidy programs that go to business or agriculture.

Senator BOSCHWITZ. Have you developed how you would achieve the reduction in medicare?

Mr. PETERSON. I can give you a list of one person's approach to it, but as a group, as you can appreciate, to try to get 500 people to agree on a 39-point program just is not possible.

Senator BIDEN. We understand the problem. [Laughter.]

Senator BOSCHWITZ. Well, as a group we have to do that.

Do you have staff that would perhaps nail some of that down?

Mr. PETERSON. We do not have a staff. We have a few public-spirited people who donate their time. We will give you an illustrative way of doing it, right.

Senator BOSCHWITZ. Let me ask also. You said $60 billion in revenues from consumption-based taxes so that you do not further reduce the savings pool. Ten different taxes have been suggested. Did you list those 10 different taxes?

Mr. PETERSON. Well, we indicated that there were a variety of approaches. For example, Secretary Connally, if he were here, and I am very sorry he is not, has recently proposed a value added tax with a rebate for exports as the European community has with some kind of a protection for the poor so that they are not adversely affected.

Joe, from time to time, I have heard you talk about value added taxes. I mentioned while you were gone that Secretary Simon, I believe, would favor an import oil fee he has indicated to me. There are a variety of approaches, but they all have that theme to them of a consumption-based tax.

Senator BOSCHWITZ. In the event we wanted to be more specific and we were not limited by this light, we would be able to draw upon your expertise?

Mr. PETERSON. Yes, illustrations, right.

GET FISCAL HOUSE IN ORDER

Senator BOSCHWITZ. The dollar is overvalued you said in your original testimony and that two-thirds to three-quarters of the GNP loss has been due to exports. What can we do about the overvaluing of the dollars? Should we adopt any type of artificial means in your judgment to do that?

Mr. PETERSON. Some of us have just testified before the Ways and Means Committee. We will be glad to do that, Senator. The single most important thing we can do, frankly, is to get our fiscal house in order and to get real interest rates down and to get borrowing down.

One of the reasons there is so much demand for dollars is that it is so attractive to put your money here with 6 and 7 percent real interest return, and we have got a tremendous demand for money.

If we got our fiscal house in order, we would have less demand than we had lower real interest rates, and there would not be so much foreign money chasing after dollars, and the effect of that vis-a-vis the yen, in my opinion, has been almost catastrophic, that yen reached 277 at one point. Even most of the Japanese, when I was last there, acknowledged it should be somewhere between 180 and 210. And if you visualize a Toyota selling at $7,000 or $7,500 instead of $5,000, you would see a dramatically different situation in market share.

So getting your fiscal house in order is part of it. There is a negotiating approach, too, that I include in that testimony. I will be glad to send it to you.

Senator BOSCHWITZ. Have those countries, particularly Japan, done anything, in your judgment, artificial to establish the value of their currency?

Mr. PETERSON. There were three of us who looked at this, Fred Bergston, who you may remember and myself and the chairman of Caterpillar that has been very severely injured, his company has, as some of you know, by trying to compete with Komatsu around the world.

The general feeling is that at this point they are not artificially intervening, if that is what your question is, in the year at this point. That may have taken place in the past. We doubt that it is taking place now.

Senator **Boschwitz**. I would be interested in your study about comparative taxes.

Mr. **Peterson**. I will see that you get that, sir. It is dramatically different.

Chairman **Domenici**. Thank you, Senator Boschwitz.

Senator Moynihan?

Senator **Moynihan**. If I am next, I will be brief. Clearly we are much in your debt—not just for this presentation but for the whole effort, which we are happy to think of as a continuing one.

MONETARY POLICY

There is one point which I think some of us on this panel miss a little bit from your first pronouncement, although it was here in your testimony. That is monetary policy.

You do speak of the catch-22 collision between tight monetary and loose fiscal policy. Last March 31, Senator Sasser, Senator Reigle, and myself presented an alternate budget—although nobody seems to know this but us. It was, it seems, a very closely kept secret.

Senator **Sasser**. We did not intend for it to be a secret.

Senator **Moynihan**. It was not planned that way, but that's how it worked out. [Laughter.] We saw monetary supplies plummetting, M_1 growth dropping from 7.3 percent in 1980 to 2.3 percent in 1981, and actually negative in the third quarter.

And we went back to the President's original money growth pattern proposed in February 1981, in his "Program for Economic Recovery." Working with the Joint Economic Committee, we put it through the economic model at the DRI, and we got some astonishing results.

Deficits over the 3-year period, fiscal years 1983–85, dropped $444 billion from the CBO baseline—with 5 percent real defense growth and $86 billion in closed tax loopholes. We got a one-point increase in inflation, but the recession would have ended by mid-1982. And unemployment today would be less than 9 percent.

Now, we ask your view of this approach. Is there not an anomaly about a government where fiscal policy is the subject of such immense scrutiny and combined political effort, and monetary policy is set by winks and nudges and secret concordats, with insufficient attention to the relation to fiscal policy?

When we did adopt a budget resolution last year, I joined with our distinguished chairman to add to it the first language ever provided by the Congress on monetary policy.

I ask you for your view. I think some of us find an imbalance in the attention given to different aspects of economic and budget policy—which cannot intelligently be separated.

Mr. **Peterson**. Senator, you probably read our statement that says that the recession has clearly been aggrevated by a collision between tight money and loose budget, and recovery requires a better balance between the two.

I am really not an expert on monetary policy, but I have listened to a lot of people who say they are experts. The one thing, Senator

Moynihan, that most of them would seem to agree on is it would be very attractive if we could, instead of presenting the Fed with the option of very loose fiscal policies, and by any standard I know anything about, 6 and 7 percent of GNP deficits are very loose fiscal policy.

And instead of presenting the Fed with the option of 6 and 7 percent deficits and what do you do with the monetary, it would be so much more possible, I think, to have a reasonable dialog by people who have put more or less emphasis on money policies versus fiscal if those deficits were substantially lower.

PLAGUED BY PROBLEM OF PERCEPTION

Senator MOYNIHAN. Let me suggest a problem of perception which has plagued us for 2 years. No one could believe that the Reagan administration would be guilty of loose fiscal policy, since it always proclaims just the opposite.

The deficits were there but somehow they were not Republican deficits. It would be one thing in a Democratic administration. Now it is another thing. And one consequence of the perception was that the behavior of the Federal Reserve was just not observed.

Mr. PETERSON. In that area, incidentally, some of us——

Senator MOYNIHAN. The Federal Reserve, at least, can perceive a loose fiscal policy.

Mr. PETERSON. Some of us have been, perhaps, more outspoken than we should have been from the very beginning in suggesting that if life were as easy as cutting taxes substantially and increasing defense expenditures substantially and somehow the expectational effects would create growth at such a rate that it would increase productivity, bring down inflation, bring down interest rates and so forth, I mentioned to some of my friends that it would have been tried a long time ago because——

Senator MOYNIHAN. Somebody would have thought about it before Mr. Laffer.

Mr. PETERSON. To increase spending and avoid the painful choices on entitlements and so forth, I cannot believe that it takes an economist to formulate that view politically. One of the reasons I think we have gotten into this situation is that many people in the administration honestly believed, I mean, I certainly believe that they honestly believed what they were saying, that the deficits were going to be much smaller and in year one we were going to have a balanced budget by 1984, and last year you recall we heard the deficits were going to be $92 billion heading toward $57 billion.

Indeed, the instance, Senator Moynihan, that got this group together was some of us having dinner together and we had done our own deficit estimates based on what we thought was more appropriate.

So at the time, if the administration were here and they are able to speak for themselves, they would probably argue that they did not think their fiscal policies were particularly loose, even though some of the rest of us believe they are. And that is the problem, of course.

Senator MOYNIHAN. We agree completely, and I want to take another moment.

Mr. **Fowler**. Well, I would be less than honest if I did not take you on on this.

Senator **Moynihan**. Well, I do not think we have the time. [Laughter.]

Chairman **Domenici**. We will make the time. You proceed.

REDUCING AND STABILIZING INTEREST RATES BRINGS CONCERN

Mr. **Fowler**. Well, I just would want today that I am on record, and I stand by it with this committee to fight inflation that I referred to before that we are as a group particularly concerned about the implications of various bills now pending in the Congress that would encourage or require the Federal Reserve to aim at reducing and stabilizing interest rates.

I am quoting. "The pursuit of such interest rate objectives under mandatory direction from sources outside the Federal Reserve," and this is a judgment, "is likely to be inflationary."

Senator **Moynihan**. "Well, I think we would agree on that.

Mr. **Fowler**. Also because it would create a resurgence of inflationary expectations in financial markets that—would put upward pressure on interest rates. It is certain to be self-defeating."

Now, if we had a Congress and an administration which, over a period of time, had sustained a equilibrium in the budget and a fiscal policy that seemed to have in mind the problems of inflation as well as the other related problems, I think you might be able to persuade me that the Congress could take a larger role. I think the Congress has taken a larger role in the Joint Economic Committee and the Banking and Currency Committees in eliciting a larger flow of information from the Fed on this question.

But where I boggle, frankly, is anything that savors of a mandatory demand that you loosen monetary policy and monetary restraint and let us tend to fiscal policy up here.

Senator **Moynihan**. Yes. May I just say that to characterize every attempt simply to call attention to the policies of the Federal Reserve and their consequences, as an effort to control the reserve—not that you so characterize it—does not advance the task of setting right economic and budget policy.

Mr. **Fowler**. Well, I am relieved to hear that.

Chairman **Domenici**. Senator Moynihan, I believe Senator Sasser is next. Are there any others? Senator Biden, you did not have any more questions?

Senator **Biden**. I do.

Chairman **Domenici**. Senator Sasser, would you let me ask Senator Moynihan a question, and then I will recognize you.

Senator Moynihan, and I ask this in all honesty, do you, in your mind——

Senator **Moynihan**. Are you differentiating between your normal questions? [Laughter.]

NO PRECEDENT SET

Chairman **Domenici**. No. I am hoping for a certain answer and that is why I say this. Do you think that politically we have already set a pattern that the annual indexation equals CPI by virtue of the Blue Ribbon Commission with reference to everything else besides social security? Have we politically set a precedent that the annual indexation is the CPI by virtue of the commission's recommendations?

Senator MOYNIHAN. You mean our commission?

Chairman DOMENICI. Yes.

Senator MOYNIHAN. Well, I would not be free to speak for the people on that.

Chairman DOMENICI. No. I am asking you how you feel about that. When we look at this recommendation, we have to say, OK, annual indexing equals CPI less 2 percent. This rule is not going to apply to social security because we have reached a settlement. My question is do you think we are at the stage where any change in the rest of CPI-indexed programs could not be possible? Do you think that we are stuck with CPI full-blown as presently defined because we did it in social security as a political, practical kind of thing?

Senator MOYNIHAN. I think you are asking me, Mr. Chairman, can we extend the principle of postponement on adjustments. The answer is yes.

Chairman DOMENICI. Not the postponement. The biggest difference between their proposal and the other is not the postponement.

Senator MOYNIHAN. And definition?

Chairman DOMENICI. Definition.

Senator MOYNIHAN. The answer is yes probably we can. Whether we will, I do not know, but we can.

Chairman DOMENICI. I was just wondering whether you thought it set the precedent for all the rest. I guess that was my question.

Senator MOYNIHAN. It set an example. I do not know that examples become precedents. You have to follow them before they become precedents.

Chairman DOMENICI. Senator Sasser?

Senator SASSER. Thank you, Mr. Chairman.

I want to commend Secretary Peterson and Secretary Dillon and Secretary Fowler for their efforts on this bipartisan commission. I think they are making a very valuable contribution to the national dialog on a critical and crucial problem that I think certainly threatens the economic health of this country and the economic health of the entire free world.

FAIRNESS OF ECONOMIC PROGRAM QUESTIONED

My distinguished colleague from New York, Senator Moynihan, has already touched on a topic that I intended to bring up, that question of monetary policy. But he did indicate that we have a problem of perception in some areas, and we, in the Congress, and I think this administration rightfully so has a problem of perception with the American people, and that is, is the economic program fair? Is it equitable? Are we calling for equal sacrifices up and down the line?

And I would respectfully suggest to this distinguished group here that perhaps there is a problem of perception in what you are advancing today and what I heard you advance in prior times on television.

For example, I hear nothing in your statements about raising the top rate of Federal taxation back up to 70 percent from 50 percent. This would reduce, according to some calculations, the deficit between now and 1987 by $10 billion, not an insignificant amount.

I am hearing nothing about repealing the selective tax breaks for the oil and gas industry, depletion allowances and the like, that could raise $15 billion in additional revenues in the next few years according to some calculations or changing the current beneficial tax treatment of business mergers and acquisitions and this is estimated to bring in an additional billion dollars.

Now, my point is this. If we are going to go to the American people as politicians and try to sell this package or one similar to it that does call for some sacrifice. They are going to have to be convinced that the sacrifice is fair up and down the line.

And Secretary Peterson, I think you very accurately characterized the economic policy as translated through the budgets of the present administration as being, I do not mean to put words to your mouth, but I think you said an inequitable burden was put on the poor, that they were the ones who were really cut in these previous budgets, and now it is time to go to the middle class and to the upper class.

What is your reaction to that? And the question, I suppose, is why do we not have a thrust in this program that goes after some of these if nothing else symbolic things.

Mr. PETERSON. Senator, just a personal word, if I may, and I feel this very deeply. I am the son of two Greek immigrants who came to this country 60 years ago, 70 years ago, and was brought up in the State of Nebraska as Senator Exon knows in a rural area during the depression.

SENSE OF FAIRNESS ONE OF DEEPEST COMMITMENTS

And one of the deepest commitments I have is a sense of fairness and a sense of stating publicly that we are not only going to reaffirm our commitment to the poor but we will prop up that safety net even more than we have.

Now, I think one answer to your question, therefore, and that is why I suggest great diligence and sensitivity in your reviewing any further reductions in that area, because as we go across this country, one of the ways we have been able to attract the people we have is to point out to them that if you really have compassion for the poor in this country, there are two aspects of that that you need.

First, you need economic growth by and large for the poor to do well, and they tend not to do well when you are not growing, and we have had zero growth in real terms for a long time, and second, if you look at the pattern of the budget cuts over the last few years, when our group first started, Joe, as I recall, the reductions in the means-tested programs, Senator, as you know, were nearly three times as great as they were to the programs that did not go to the poor.

At the end of last year, they were twice as great. As we compute the numbers today, even today, they are greater for the means-tested programs than the nonmeans-tested programs.

So one way of addressing your fairness issue, I think, is to really mean it with regard to the poor, and that is a very important principle to me personally and very important, I think, to all of our numbers.

Now, on your second point, you would find me very supportive of subsidies of various kinds and so forth. Senator Moynihan will recall that at the time that—and deregulation and so forth, at the time I went into Wall Street, some of my colleagues were suggesting that we come up and testify on the subject. You will remember, Senator, the whole question of competitive rates on Wall Street and so forth, and my point of view about that was we ought to try to get rid of a lot of those regulations for all of us because we ought to compete, and you know 7 years later, 8 years later, we have all done well and so forth.

I would be enormously satisfied looking at subsidies and regulations to all of us and minimizing those in the business sector.

EMPHASIS PUT ON SAVINGS

Now, let me tell you where you get into trouble, however, and that is why we put so much emphasis on the savings, Senator. It seems to us that it is terribly important that you not look at tax increases as a one-for-one exchange on deficit reduction. What we are trying to say is that if you use the kind of tax increase that reduces that top number up there on saving, you have not really left anything more at the bottom line to invest in the economy.

So we think it is extraordinarily important that you just not say or as some do, this brings in $10 billion; therefore, it reduces the deficit $10 billion, because if it reduces savings by some number close to that, you are still left with the same problem in terms of savings available for investment.

So I would suggest that the model that might be useful is to examine what the effect of a given provision is bottom line on what is left for us to invest in our future. Some taxes have a much more negative effect on savings than others.

The reason we propose a consumption tax, with protection for the poor, is that we think that has the least effect on reducing the level of savings in this country, while being fair.

So I think you have to ask yourself what you are trying to achieve. What we are trying to achieve is to increase that bottom number that is available for investment in research, in training and education and infrastructure and so forth.

So I would suggest that you compute the effect on the net savings level rather than just the deficit level.

Senator SASSER. Well, we in political life, as you know, Mr. Secretary—excuse me.

CLOSING THE LOOPHOLES

Mr. DILLON. I would just like to add a little bit to your question, Senator. During my time in the Treasury, we spent a great deal of effort and time trying to close loopholes and we had some success.

Mr. Fowler was very helpful to me. He worked with me on that. Later on, when he was Secretary, he succeeded in getting some more closed. But we found out one thing and that is what is one person's loophole turns out to be some other person's or lots of other people's bread and butter, and it was very hard when you went about this to get agreement, enough agreement to really do anything.

I would still be very much in favor, personally, of closing any loopholes that you can get any measure of agreement on, and I think there probably are some, but another thing we found out was that those kind of loopholes closing do not bring in anywhere near the kind of money that we are talking about and that we need.

Senator SASSER. Well, that is understood that they do not bring in the kind of money.

Mr. DILLON. But I think we should do it.

Senator SASSER. But what we are talking about here are perceptions, and we in political life have to sell these perceptions as you three distinguished gentlemen know, and let me just say this before yielding to Secretary Fowler.

Secretary Peterson, we had your successor, Secretary Regan, was up here I guess a year and a half ago.

Mr. PETERSON. He would be disappointed to hear that. You do not mean Secretary Regan. There is not a Treasury Secretary alive that would prefer to be a successor to a Secretary of Commerce, I can assure you of that.

Senator SASSER. Excuse me. But Secretary Regan was here and I was questioning him about this tax cut of 1981, and I said:

> Mr. Secretary, this does not seem to be fair. The upper brackets are getting so much more percentagewise than those in the lower brackets and getting so much more in real terms than those in the lower brackets, and it appears to favor the wealthy considerably.

And his response to that after a long dialog back and forth was that he said:

> Yes, it does. We have no apologies for that, because what we are trying to do is to create funds for investment, and the wealthy save and they create savings that can be used for capital investment.

Well, we passed his tax cut, and we see now that it is going to cost us over the next 5 years over $1 trillion, and I frankly do not see any increase in savings.

Mr. PETERSON. Senator Sasser, there are some of us who occasionally are not consistent, not often but occasionally. If you will read my testimony before the Joint Economic Committee in March 1981 and in an address that I made in March 1981, I suggested that I thought the American people, looking at the example of Japan, looking at the sense that we were not saving enough, would have been prepared to accept a tax package that focused on the capital formation problem.

As a matter of fact, with wide predictions in 1978 when Congressman Steiger and others, and Senator Moynihan will remember this, that there was going to be a big political revolt over that capital gains issue and that we were going to lose revenues and so forth. What happened?

Two years later, the Federal revenues are up $1.7 billion. It has made capital flow more, and I am not aware of any political revolt. To me the advantage of focusing that tax cut at that time on savings and investment is that it would have been a smaller tax cut and it would have been targeted on the problems of the country.

And at that time a number of us also proposed that why do we not get at these nonmeans-tested entitlement programs, not the programs to the poor, but the big 100 percent indexed programs because those are the ones with the huge unfunded liabilities when the bills are going to come due.

There are some of us, as Senator Moynihan knows, who have proposed and as he knows I would go even further, but I think one of the significant contributions of the social security commission is to attack one issue of equity. Why on earth people in middle and upper income groups should get back a lot more from social security than they put in, tax free, is a concept I do not understand.

Now, I would go a step further. I would say tax all of it in excess of your contributions, and that give me an even better sense of equity, but, Senator, I think that was an important step in the right direction.

INVEST IN PLANT AND EQUIPMENT

So I come back to if we could just get agreement as we are trying to do, Senator, probably not very well, on what the primary problem of this country is which I think is investing in our economic future rather than mortgaging it, and we did that rather than formulating highly optimistic theories about psychology and so forth and just gave people bottom line incentives for doing what we as a country have decided we want to do.

You could create a consensus around that, and I am finding across America that Democrats, Republicans, people in the center know we have to invest in plant and equipment. I mean, with the Japanese with plants half as old as ours, with two-thirds of the robots in the world, with more than half of the orders for new robots, with spending three times as much as we are on science, on education, on engineering graduates, you do not have to be an economist to understand that 10 years from now we are going to pay the price for that unless we invest more.

Senator **SASSER**. We are paying it right now.

Mr. **PETERSON**. We are paying it right now. And I argue that you can create a consensus in this country for more investment. I do not think that is a problem in America if we would focus on that objective. I am sorry for the speech.

TOP MARGINAL RATE IS GREAT DETERRENT TO INCENTIVE

Mr. **FOWLER**. My colleagues have covered this subject pretty well, but I would like to add one footnote. You mentioned why did we not raise the top rate back up to 70 percent.

Well, I was brought up in tax policy associated with Douglas Dillon, the Secretary of the Treasury and John F. Kennedy as the President, and the tax program that we came up with, the first major element of it was the so-called investment tax credit because we felt that is what America needed to do just the kind of things, a beginning to do just the kind of things Secretary Peterson has described.

The second bill, the so-called Kennedy-Johnson Tax Act, we proposed that there be a decrease in the top rate from then 90 percent to 65 percent. The Congress made it 70 percent.

From my own point of view I have felt that that top marginal rate is a great deterrent to incentive and to saving and to investment, and I have no apologies at all for taking that position and saying I am a John F. Kennedy, Douglas Dillon, Lyndon Johnson type of Democrat who believes in that the kind of incentive based tax policy having to do with the top rate, as long as there was a marginal reduction of an equivalent nature on the way down, is an appropriate approach to making the country move again.

Mr. PETERSON. Senator, if I can just tell you one brief anecdote. I was a guest of the Japanese government last spring and met with a number of people in the Finance Ministry. And one day a member of the Finance Ministry asked me a very embarrassing question. I would like to ask you this question.

He said:

> Mr. Peterson, I hear all your politicians and all you people talking about how you are for capital formation and you want to encourage investment. Tell me, sir, why would you have had the highest tax on something you call unearned income?

That is, from dividends and savings.

He said:

> The way we look at it the most earned income of all is the income you earn on your savings, because that is hard work, saving. It means that a person has to decide to save rather than consume. Our tax rate on investment income is at the lowest levels, not the highest levels.

Now, what I am trying to suggest to you is if you get your eye on the ball that you want more investment, there are ways of doing that that other countries could lead the way on that need not cost you the $1 trillion that you were referring to earlier, if you just agree on what your objective is.

Senator BOSCHWITZ. If you would yield.

Senator BIDEN. No; I would not yield at all. I want to take all my 25 minutes like everybody else does. Can I just ask my questions, Mr. Chairman.

Chairman DOMENICI. Yes.

Senator BIDEN. First of all, I think you have made, and I am being very redundant, a tremendous contribution. I really mean it. I should note parenthetically in the last year and a half I have never seen so many Japanese Democrats in my whole life.

The President is a Democrat when he wants to quote anybody. Every economist is Japanese when he wants to talk about the economy. We are all Japanese Democrats. Let us accept that at the outset and move on.

And by the way, Secretary Peterson, we would be a lot better off if you were a Secretary of Treasury right this very moment. Now, let me ask my questions, and maybe they can get relatively short answers since some of the ground has already been covered and mainly for clarification.

JAZZING UP THE ECONOMY

Secretary Fowler, you said it is possible to, "jazz up the economy in the short term but it will fizzle unless we do these things." Let me ask you a very practical political question.

All we politicians know that Presidents ask Secretaries of the Treasury when they are up for relection, "can I jazz it up between now and November 1984 and get by until then?" Is it possible without doing any of this to, "jazz it up," keep the recovery going without it being apparent to the body politic that it is going to fall on its face?

Mr. Fowler. I doubt the level of sophistication and education in the country has driven that fact home that I uttered, namely, that you can stimulate and you can overstimulate and you can stimulate for various reasons, but your stimulation must be geared to a noninflationary pattern.

Senator **Biden**. I understand that, Mr. Secretary, but I mean, look, we have all been there. We have all been asked by our counterparts. When Carter was President, he would call me down and say, "Well, what do you think I can do to get such and such done?" And I am sure Presidents asked you the same question, notwithstanding the fact that all Presidents are interested in the national good.

The fact of the matter is they are also interested in elections, every President, Democrat and Republican alike that I have ever observed and I have only met four of them myself. I have only been here 10 years as a student of Presidential politics.

So what I am asking and I am not being facetious. I guarantee you the President is going to be asking somebody or Mr. Meese or someone is going to be saying to their economists,

> Look fellows, we got a lot of bad medicine we got to swallow. We are in real serious trouble. We are going to lose an election potentially if something does not happen. Now, can I jazz this economy up, keeping inflation rolling without us rolling into double digit inflation, keeping the economy going so it looks like we are in good shape and we can continue to have news stories once a week with me in Detroit or someplace else showing new people put back to work?

Not the question of whether it is going to fall flat on its face later.

Can that be sustained between now and November 1984, in your professional opinion, and you know as well as I do they are the kind of questions that we politicians ask. We may not do it, but we at least ask them. Can that be done in your professional opinion?

Mr. **Fowler**. It is hard for me to project myself into the position of being either the asker of that question or the fellow who answers it.

Senator **Biden**. Well, I will withdraw the question then, but I find that somewhat surprising and quite frankly I think——

Mr. **Fowler**. I have never run for office so that accounts for it.

Mr. **Peterson**. Senator, I will take a crack at it. In the first place, if we were running for office, we probably would not be advocating this program as frankly as we are, but if we have any contribution to make, maybe it is because we are not running for office.

But ironically enough, I happen to believe that doing what is right may well be the best politics in this situation, and I am not interested, frankly, in jazzing up the economy. I am interested in 10 years of growth not 18 months of growth.

And in my judgment, if we do not get these long-term real interest rates down by presenting a credible story about the future, any recovery you are going to have not nearly as sustained as it ought to be, and whether you can jazz it up through 1984, I do not know, but I am not very interested in that.

Senator BIDEN. I am not suggesting you all for any fault. I was asking you and maybe the question is just not appropriate but let me put it another way. Nonelected officials are oftimes asked by elected officials who are running for office what is the least painful way for me to get by my election, and they go to the professionals, whether they are in the defense area, whether they are in foreign policy area, whether they are in economic areas.

And my experience of watching this outfit for 2 years, not this committee, Mr. Chairman, this administration, I have seen less than candor come down the road. But let me withdraw the question. The next question.

CONSTITUTIONAL AMENDMENT

Would any of you suggest that a reasonable person could argue for a constitutional amendment requiring a balanced budget between now and the year 1990? Could anybody reasonable suggest such an approach in your opinion?

Mr. PETERSON. Senator, if you are asking me my choice which was to put this program into effect, because there are no answers now that are not painful. That is the message that we are trying to convey. Or, give me a balanced constitutional amendment that any ingenious person with a little bit of foresight and so forth can figure out ways to avoid, I will take a program put into place every time. If you are willing to attack those programs which you are going to have to do, you might as well attack them, and having an amendment is not going to make it any easier to attack, in my opinion.

Senator BIDEN. But the point is there is no way to balance the budget, is there?

Mr. PETERSON. Oh, that's right.

Senator BIDEN. So anybody who would offer a balanced budget amendment has to be a phoney or stupid.

Mr. PETERSON. Well, I am not going to——

Senator BIDEN. Well, would you characterize it your way? The reason I say this is I am so sick and tired of the American public being led astray by somebody standing up there who is convincing on the tube, and then we go home, we who run for public office, attempting to act responsibly and are asked by our constituents, "Well, why do you not just vote for a balanced budget? And you say we got to take painful steps." They say, "There are no painful steps. The man just said if we had constitutional amendment, the balanced budget would be solved."

And I think it is incumbent upon responsible people to say that is hogwash.

Mr. PETERSON. I will say to you, sir, that as a general rule, and this is no exception, if I hear somebody with a problem this complicated tell me he has got a single treatment, whether it is a balanced budget or, forgive me, Senator, just money policy—I know you are not advocating that—but just easing up on the money or just the gold standard or just something that is easy and simple, I know that is not the right answer.

Every answer that I have been able to think of involves very tough political choices. Anybody that tells you anything different than that does not understand the problem.

TANGIBLE SACRIFICES

Senator BIDEN. Very helpful. Several more specifics. This is a quote, the ad says, "The program that we support would require tangible sacrifices from many middle and upper income citizens," end of quote.

Now, what specific, tangible sacrifices do you suggest, because as I look at your proposal without getting into the tax question even, as I look at your proposal, by and large, you say, "By and large, the poor have already paid their price in this deficit."

Mr. PETERSON. Let us even beef it up, support it, right.

Senator BIDEN. Now, the one thing I see in your program is the social security suggestions, but that is not much of a sacrifice from the wealthy and that is not much of a sacrifice from upper middle income people.

Can you tell me what are some of those tangible sacrifices that you suggest the middle, upper middle income and wealthy people in America are going to have to make?

Mr. PETERSON. Starting with social security which is 27 percent of the budget, very large amounts of that, as you know, go to——

Senator BIDEN. That does not affect wealthy people.

Mr. PETERSON. Now, we said middle and upper income, Senator, not just—there are not many wealthy——

Senator BIDEN. That does not even affect upper income people.

Mr. PETERSON. What?

Senator BIDEN. Upper income people do not care about that. It is not a drop in the bucket. Capping the COLA, delaying the COLA for an upper income person or an upper middle income retiree, it is malarky to say that, in fact, is a sacrifice.

Mr. PETERSON. Well, I will tell you if, indeed, that is true, then I would urge you to put in the taxation proposal I recommended in which you tax all of it above contributions, because that is another argument for doing it.

Senator BIDEN. I agree.

Mr. PETERSON. OK. Now, as far as the pensions are concerned, for example, and I know I am really stepping on some toes here, but I would really like to urge a bottoms up appraisal of total compensation for Federal and military employees.

I speak from the vantage point of having chaired the Quadrennial Commission for President Ford, a job I will never take again. But I can assure you that in the course of that inquiry when I asked the question, "Tell me about total comparability on total pay, not just the cash but the fringe benefits and the pensions," it was almost impossible to get the answer to that question.

Senator BIDEN. I agree.

Mr. PETERSON. Among the amounts we are talking about, and that is why we did this work here, are Federal pension programs that clearly go to middle and upper income groups who are receiving pensions often larger than the people working full time. That is another example of such a program.

Chairman **Domenici**. Did you put military in there?

Mr. **Peterson**. I certainly would, sir. In fact, I could argue that the current military pension policy is not productive of keeping the people in the military that we ought to keep in the military, but that is another subject.

Senator **Biden**. I would agree that is tangible. What are some of the other tangible things other than retirement benefits, whether it is social security or another?

Mr. **Peterson**. But of course, the entitlement programs which are retirement programs are a vast part of the nondefense programs. By the time you take social security and all these pensions, you are up to 70 to 80 percent of what we are talking about.

Senator **Biden**. I am not trying to be argumentative. I am just trying to make sure I get it here.

Mr. **Peterson**. But that is a very important part of the package.

Senator **Biden**. And medicare would be another one?

Mr. **Peterson**. Medicare, clearly.

Senator **Biden**. I am trying to go through it as quickly as I can, Mr. Chairman, just a couple more specifics. You put together a program which has obviously received wide credence from a number of people and a number of groups, and I understand your desire to reduce the deficits as quickly as possible and how dangerous they are to our economic health.

SOME PROGRAMS CARRY RISKS

But I assume that in doing so, some of these proposals carry with them some risks I would guess. We obviously know what the risks are of not doing anything. They are sizable and they may be absolutely the time bomb you refer to.

Now, I would like to ask any one of you or all of you to evaluate some of the other risks that I am told by people, and I share the thrust of your view as to how we should go along this way.

Now, I am not an advocate of supply side or Roth-Kemp and all of that. All right. Having said that, but I am told by people whom I respect that there are some risks, including people on my staff who have not supported those proposals either but now say it is too late to do some of them.

For example, what is the risk of cutting what amounts to $145 billion in stimulous from the budget during a sluggish recovery? They said, "Biden, OK, you go along with that bipartisan group and really what you are doing is taking $145 billion away."

Mr. **Peterson**. No.

Senator **Biden**. What is the answer?

Mr. **Peterson**. I beg to differ with you, sir. We believe that the tax aspects that we are discussing should not be in the context of one of the deepest recessions we have had. We are talking about sending a signal to the financial markets that your 1985 problems are going to be taken care of when you are growing. That is an enormously important distinction.

Senator **Biden**. How about the spending portion?

MARKETS ARE LOOKING FOR SIGNAL

Mr. **Peterson**. Well, here again, the word I used was signal versus actions. If you were to tell the financial markets today, Senator, and I do not expect you to do it, but I can have my fantasy, that beginning next July 1, just to take a for instance by which time the growth is apparently here, we have decided to put into effect the tax increases, the defense cuts, a 1-year freeze in indexing, beginning out in the future but announcing it soon or announcing it the first of next year—I am not hung up on the precise timing—I am trying to say that what the markets are looking for is a signal that you have taken action now that is going to go into effect in 1984 or 1985, and if you did that, I will take the side of the bet that says that long-term real interest rates will start coming down significantly and your recovery will be much stronger and more balanced.

So you do not have to do something in 1983, and I am not sure I know what you could do. You could phase in the spending cuts. There is a lot you could do.

Frankly, there is a lot here being said about Paul Volcker. I think Paul Volcker has got one of the toughest jobs in America.

Senator **Biden**. I did not say anything about Paul Volcker.

Mr. **Peterson**. If Paul Volcker were to see long-term structural, fiscal stuff put in of the type we are talking about, you might find him being a lot more accommodating on monetary policy, and then you would have low interest rates and a recovery in the long term.

Senator **Biden**. What I am trying to get at is all of you have been around this town a lot longer than I have, and you understand how this place works, and it is very difficult to bind future Congresses so we are going to have to do something very specific ourselves here and now.

And even if we said that, and I am ready to sign on to what you say.

Mr. **Peterson**. Right.

Senator **Biden**. Now, I do not have any problem with that, but what my problem relates to is whether or not we can, in fact, credibly send a signal without taking some of the actions this year now in all three of those areas, because I do not believe anybody out there in those markets would believe it.

Who is going to believe we are going to bind another Congress or even bind the second half of this Congress the way we work. I have not seen that happen very often.

Mr. **Peterson**. But assume that you phased in a freeze with an indexing program beginning next fall.

Chairman **Domenici**. But you passed it.

Mr. **Peterson**. You passed it now but you started it then. Believe me, and assume that you passed a tax increase and you pass a defense budget, I am saying to you, Senator, those are the kind of signals that the financial markets are waiting for.

Mr. **Fowler**. Also, Senator, I think if it were a bipartisan supported program, it would carry a lot of conviction that it was not just something that was done and then the rug was going to be pulled out in another year or two.

Senator **Biden**. I agree. I have many more questions, but you have been extremely patient. We have trespassed on your time a lot.

MOVE IN BIPARTISAN DIRECTION

I cannot think of any testimony we are likely to hear that can potentially have as much impact on the formation of the one thing that is absolutely critical for us to get out of this whole mess, and that is to truly, to truly move in a bipartisan direction and stop the internal sniping, and both of us acknowledge that we really do not have the answer.

But the only thing if you figure it out that the entire Congress seems to agree on is the President is wrong. I am not being facetious. I am not being facetious. You heard Senator Symms. Senator Symms is not somebody from the left wing of the Democratic Party. I have not heard anybody in here nor did I hear last year anybody say the President is right on course. So I hope we can get some answers.

Mr. **Peterson**. Senator, would you agree with me, though, that the three of us at this table are wrong because it was the administration that I was a part and forgive me, Senator Moynihan, you were a part of, even though Secretaries of Commerce and you probably did not have much influence on it, it is that administration that put in the huge increases in social security, the indexed programs 100 percent. So we are all part of this problem.

Senator **Biden**. Just so you know, and you had no opportunity to be here, but in opening statements this morning, I started off my statement by saying that I will, for the sake of discussion, agree to everything that the Republicans say about how bad we Democrats are and by the way, a lot of what they say is absolutely true, if they will stipulate to the fact that this President does not know what he is doing—I am serious—and second, if we, in this Congress, on the Democratic side acknowledge we do not have a total answer and the Republicans will back off what has been a not very worthwhile policy.

If we can start from that basis, we are all in good shape, but if we do not, there is no hope. I am sorry to do it such rapid fire, but it is a long time. Thank you.

Chairman **Domenici**. Let me say to the three of you, I know you have had vast experience in Government, but I think it is fair to say to you that you will not find many hearings between 3 and 5 on an afternoon such as this one when there is a real chance there is nothing left to do the rest of the week in the U.S. Senate. We do not have anything on the agenda yet. You will not find a session when 12 or 14 Senators stay 2½ to 3 hours.

So first I hope you understand that we are very interested in what you have to say. From what I can tell, although I had to absent myself a little bit, and I apologize for that, it was worth their while. I have a sneaking hunch it might be worthwhile for this whole committee.

SIMILARITY BETWEEN BUDGETS

I want to ask you to do a couple of things for us. Frankly, while Senator Biden has his approach to explaining the President's budget, I want to tell you that I see a very, very significant similarity between the theory of the President's fiscal year 1984 budget and yours. Both are based on the theory of wedging, that you start with small savings and make sure they get big but put them in place. That is what I understand about your proposal.

They both carry with it the premise that you do not put any new taxes on until you get through a recovery. The only difference between the two is that you say consumption taxes and you say a year earlier. The dollar numbers are damn near the same. You say 60. The President says somewhere between 45 and 55.

Mr. PETERSON. And we say not contingent.

Chairman DOMENICI. Wait a minute, but taxes that he mentions are going to be put in place. Frankly, the President does not assume that it is contingent in the sense being discussed. We may never be able to write it, but it would be just as real in terms of sending a message to the marketplace to pass the tax now which would come into effect in the future.

The only other major difference is the defense number. I would ask you if we could impose on your gratuitous time to do us two or three favors. First, could you as soon as possible give us whatever backup information you have on the defense saving?

While information is tough to come by, I would hope you did not just use percentages and that you have something to back it up. If you can get us that, we would appreciate it. That is No. 1[1].

No. 2, now that the President's budget is out, could you impose his budget on yours and assume that some compromise has to be made? You have as much as told us, Secretary Peterson, that you do not think your budget could get passed. I do not either. I do not think the President's can in its entirety either.

But maybe you could take the time to look at where the trends go and see if you could come back to us with some middle of the road recommendations in terms of how his might be made better in terms of accomplishing your goals.

You obviously cannot sit here as intelligent people and tell us that $75 billion as the deficit number in 1985 is right on the money. I think you would agree with us if we had everything else in place and it was $95 billion you might come here and cheer.

If you could do that for us, it would be greatly appreciated. I am going to make one last observation. I have never made it before. I wish the Chairman of the House Appropriations Committee was here and I wish Senator Mark Hatfield was here.

LATE START IS BASIC MISTAKE

I have looked at what we have done with fiscal policy. In a nutshell, the accounts of this Government that have to be voted on every year by the Congress, to wit, appropriated accounts, are the ones getting cut. The accounts that are automatic are the ones we refuse to change, and I do not think there is any doubt that there is a major lesson to be learned in that.

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[1] See p. 329.

People around here are always giving the appropriators hell. The truth of the matter is they are the ones that cause reductions in this Government. It turns out that the reductions are in the means-tested programs, and those programs were the ones that were appropriated every year.

If we made a basic mistake on the fiscal side, it was starting 2 years late in addressing the entitlements. Had we addressed them from the very beginning, we would have a much better chance of being in a better fiscal posture, but in this country it is never too late. We have got to do it now.

So I would ask you to take one last effort with the best talent you have got and impose your budget on the President's and see wherein the similarities of thrust are, and see if you can give us another packet of recommendations of some midpoints if you might. Could you do that for us?

Mr. PETERSON. My guess is that if we do that, it may be just the six of us because I have a business I am presumably running and the thought of getting 500 people to agree on a detailed program is a lot.

Chairman DOMENICI. We do not expect another ad. We do not expect 500. We expect your expert advice and only to the extent that you have time available.

Mr. PETERSON. Perhaps we could elaborate on this signaling idea that we have.

Mr. FOWLER. You will indulge us if we do have a degree of humility about responding to your questions. I mean, there are large areas, and I mean we are 13, 14 years away from this town. You lose a feel for the detail.

Chairman DOMENICI. Of course. Let me assume also so it makes your job easier. For purposes of my request, and it is nothing more than mine, you do not have to worry about whether the means-tested programs that the President cut ought to be cut or not. You can assume that they ought not to be if you wanted and plug in that $10 billion over the next 5 years. I think that is what it amounts to. It is about 2.5 percent of the deficit reduction or less. You can just say you should not make any of those.

Somebody around here is going to decide how much should be cut. That is appropriating. That is not all that tough. Either they will do it or they will not do it on an annual basis. It is the other areas that are the tough ones.

1985 IS KEY YEAR

Senator RIEGLE. Mr. Chairman, would you yield just for one point because it seems to me that our witnesses have said that as they see it, 1985 is the key year, and we do not specify that in terms of the sequencing things, but you just had a discussion on revenue items, and the President talks about his revenue items kicking in in 1986 and beyond.

And if they are going to do additional work and we are going to try to dovetail these things, then I think we better have an understanding whether 1985 is the year that we are keying on and whether that is the one that the markets pay most attention to, because if we put the package together and it hits at the wrong time, then we have not gotten the job done.

Mr. PETERSON. You might be interested in why we picked 1985. There were a set of reasons having to do with giving a signal soon enough because people discount things that happen too far in the future, and frankly, politically, if I may say this, we decided on 1985, I think, Joe and Doug, for a couple of reasons.

First, one of the reasons the market is not accepting the contingent idea out in 1986 is the notion that it is a little awkward to think of Congresses passing taxes for other Congresses.

Now, 1985 happens to be a year that you all will be here and you can take the responsibility for your actions. Second, we are not unaware that the Social Security Commission has met and it has worked very hard and a lot of great people have done what they could.

I guess we would like to see a little more on some of the freeze or indexing or whatever, but in any event, that also gives us a year to go out to the public and start talking about some of these programs.

So that is the signal that we think is important.

ADD ASSURANCE TO REVENUE BASE

Chairman DOMENICI. Let me say, Senator Riegle, I do not have any pride in authorship in what I asked them to do, and it is not singularly something that only they could do. I mean, staff, obviously, understand the differences.

But right off you can see that they are asking that a consumption type tax amounting to $60 billion come in in the year 1985. The President is asking for a trigger tax to come in somewhere between $40 and $60 billion in 1986.

There is not any magic to this. If it turns out that it is $25 billion in new revenues in 1985 and the balance of Mr. Peterson's $60 billion in new money in 1986, I would assume that they are not going to come around here and say that is wrong if I understand their premise.

The premise is to add assurance to the revenue base after you have made the budget cuts so that you bridge that gap that still exists with certainty on the revenue side.

Mr. PETERSON. Your key word, Senator, is assurance. The contingent tax may not give that sense of assurance. That is all we are trying to say to the financial markets, because there are variables involved and interpretations and so forth.

We think that the deficit is so large under any circumstance that you just ought to put it in. That is all.

Chairman DOMENICI. Anything else?

[No response.]

Chairman DOMENICI. Thank you very much. We are most appreciative.

Mr. PETERSON. Sorry to keep you so long.

Chairman DOMENICI. I am pleased to call on our second panel, The representatives of these organizations constitute a major portion of the Nation's business community. The panel members are:

Jack Albertine, president of the American Business Conference; Mike McKevitt, director of Federal legislation for the National Federation of Independent Business; and Paul Huard, vice president for taxation and fiscal policy for the National Association of Manufacturers.

These threee groups have joined together to call for bipartisan action from the Congress to reduce projected Federal deficits and to reduce economic growth to our economy. I must say that I am in total agreement with that goal. It is only through the health and growth of your business memberships that we will be able to continue on the path of economic recovery and increased employment. I am interested in hearing more details on your proposal and any other comments you have on the President's budget.

What is your pleasure as to how you want to proceed?

Mr. ALBERTINE. I will start, Senator.

STATEMENT OF JOHN M. ALBERTINE, PRESIDENT OF THE AMERICAN BUSINESS CONFERENCE

Mr. Chairman, my name is Jack Albertine, and I am president of the American Business Conference which is an organization of chief executive officers of midsize, high growth companies.

BUDGET PROBLEM NEEDS BIPARTISAN APPROACH

I have a statement which I will not read.[1] In the interest of brevity, I will make a few comments and turn it over to my colleagues. First, I think it is certainly the view of the American Business Conference that we ought to have a bipartisan approach to the budget problem. I do not think there is any question with respect to that.

Second, I do not know that you would find too many people who would disagree with respect to the analysis which Secretary Peterson gave of what, in fact, is going on in the economy.

There is no doubt in our mind certainly that there is significant room in 1983 for the Federal Reserve to continue its policy which, in fact, is expansionary, and that the result of that will be a recovery which I think is already underway. My own view personally is that the recovery is likely to be a little faster than the administration predicts.

TAKE ACTION ON DEFICIT IN OUTYEARS

The second point of the analysis is that there is no doubt that as you move toward full capacity in this economy, at the end of 1983 into 1984 with these outyear deficits looming on the horizon, either Federal Reserve policy has to shift, in which case we will get crowding out, or Federal Reserve policy will not shift, in which case inflationary pressures will be renewed, and it is likely that the financial markets will react by forcing interest rates up, and the recovery will be aborted.

I do not think there is any question about that. This recovery cannot be sustained unless there is action taken on the deficit in the outyears, fiscal 1985, fiscal 1986, and beyond.

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[1] See p. 218.

Two weeks ago, these three organizations called for a 25-percent reduction in the deficit in fiscal year 1984 through spending reductions, and we talked about the areas where we wanted to see additional reductions made, and we focused on all of the areas that Secretary Peterson focused on, including defense spending.

With respect to the President's budget, he comes relatively close to the recommendations that we made. If you take his baseline assumptions, that is about an 18-percent reduction in spending over current services. If you take a 1-percent increase above his baseline in terms of economic growth, which is conceivable, it comes out to about 23 percent.

So the President clearly has moved in the direction that we were calling for. Certainly, the American Business Conference would like to see further cuts in defense.

We obviously would like to see further cuts in the entitlement programs and discretionary spending. Where I think we would have some disagreement with Secretary Peterson and the Peterson group is in the area of their proposal on taxes.

And let me say, first, Senator, that the American Business Conference led the fight in the business community last year for the tax increase which was largely a tax increase on business, and on savings and investment, not because we thought it was good policy, because we did not think it was good policy. We led the fight because we thought it was the right thing to do in terms of getting everybody to agree to some spending reductions and on an overall attempt to get the deficits under control.

But with respect to Secretary Peterson's recommendation, I would have just a couple of comments that I would urge you to look at.

CONSUMPTION-BASED TAX INCREASE

One, he is talking about a consumption-based tax increase. Now, as I look at the calendar, of course, there are lots of ways to structure this, but it would occur October 1, 1984. As I misspent my youth watching the Congress operate, there is some doubt, in my mind at least, that the Congress is about to pass a consumption-based tax increase to take effect October 1, 1984.

Now, maybe that will happen, but I would have some doubts about it.

TAXES ON SAVINGS AND INVESTMENT

Two, I think what is likely to happen if there is a tax bill for fiscal 1985, is that it is likely to be a tax bill which not only hits consumption but probably is going to hit savings and investment, and I could not agree with you more that, to the extent to which you put taxes on savings and investment, you lower the savings pool, does not really give you any benefit with respect to interest rates.

THIRD DIP OF THIS RECESSION LIKELY

Three, I must say that he may have a much better handle on what is going on in this economy than I do. But I could write you a scenario, Senator, that on October 1, 1984, we will be smack in the middle of a third dip of this recession. I can also write you a scenario that that will occur even if the entire program which the Peterson group has proposed is enacted lock, stock, and barrel.

And there are obviously a lot of other people in the financial community who could write you this same scenario, in which case either you have got a tax increase that you are going to regret, or, at some point prior to when the increase goes into effect, you will have to repeal it.

And the notion that somehow the financial markets are going to be convinced that this tax increase is going to stay, even if it were enacted this year, is not believable.

So I would, for those reasons, advise you to be very cautious before you go ahead with that tax increase.

I think the best thing you could do is to make the spending reductions which are necessary in 1984, and I think you may have to take a look at taxes in fiscal 1985 and 1986, but I think the time to take a look at them is after you see what in the world is going on with respect to this recovery.

Thank you very much, Mr. Chairman.

Chairman DOMENICI. Thank you very much, Mr. Albertine.

TESTIMONY OF
DR. JOHN M. ALBERTINE,
PRESIDENT OF THE AMERICAN BUSINESS CONFERENCE
BEFORE THE
SENATE BUDGET COMMITTEE

FEBRUARY 2, 1983

GOOD AFTERNOON. MY NAME IS JACK ALBERTINE, AND I AM THE PRESIDENT OF THE AMERICAN BUSINESS CONFERENCE. THE AMERICAN BUSINESS CONFERENCE IS A COALITION OF THE CHIEF EXECUTIVE OFFICERS OF NEARLY ONE HUNDRED MID-SIZE, HIGH-GROWTH COMPANIES. THE MEMBER FIRMS OF THE ABC HAVE ANNUAL REVENUES BETWEEN $25 MILLION AND $1 BILLION, AND EACH HAS DOUBLED IN SIZE OVER THE LAST FIVE YEARS. BECAUSE OF THEIR FANTASTIC GROWTH PERFORMANCE, THESE FIRMS REPRESENT THE WINNERS OF THE AMERICAN FREE ENTERPRISE SYSTEM.

Two weeks ago, the American Business Conference joined with the National Association of Manufacturers and the National Federation of Independent Business to call for a 25% reduction in the projected deficit for fiscal year 1984. We made that statement because we were, and continue to be, concerned about the impacts which these huge projected deficits would have on the long-awaited economic recovery. Economists have been waiting, like expectant parents, for this recovery for almost a year and a half. On the basis of recent economic data, it now appears that this illusory recovery has finally started.

The Index of Leading Indicators was the icing on a cake of good economic news for December. Inflation remained low, and interest rates edged lower. Even the labor market appears to have stabilized. New claims for unemployment insurance continue to fall. The help wanted index posted a strong gain in December, following two months of smaller increases. Last week, General Motors announced a recall of over 21,000 auto workers.

While the preliminary GNP figures for the fourth quarter of 1982 showed a decline, this was mainly the result of the final drawdown in inventories. In light of the decline in inventories, the auto industry has already acted to step up production. As the auto and housing industries continue their recoveries, the rest of the economy will fall into line. Unless there are weather-related distortions, I think that the statistics will show that industrial production rose in January.

However, I doubt that this recovery can be sustained unless you take serious steps to cut spending. Businessmen are alarmed by the tremendous escalation in the size of the Federal deficits. They believe that deficits of this magnitude will put tremendous pressure on the financial markets. Sooner or later, like it or not, huge deficits will push interest rates back up.

I think that even a moderate increase in interest rates in the next twelve months could cause the recovery to stall. With 12 million Americans out of work and with tremendous competition from abroad, we cannot afford to let the economy slip back into a prolonged recession. We must keep the deficit as low as possible by cutting spending as much as possible. While I certainly applaud the Administration's efforts to cut spending, I hope that you will give the President even deeper budget cuts than he has requested.

Two weeks ago, we called for a spending reduction of between $45 and $55 billion. The President's FY 1984 budget submission includes savings of $35 billion over the current services budget. We asked that the FY 1984 deficit be lowered by 25%. The deficit in the budget submitted by the President is 18% lower

THAN THE CURRENT SERVICES DEFICIT. IF THE RECOVERY IS 1% STRONGER THAN THE ADMINISTRATION'S BASELINE, AND I THINK IT CAN BE, THEN THE DEFICIT WOULD BE MORE THAN 23% BELOW THE CURRENT SERVICES LEVEL.

IN THIS CITY WHERE ADMINISTRATION FORECASTS HAVE OFTEN BEEN OUTRAGEOUSLY OPTIMISTIC, MARTY FELDSTEIN'S FORECASTS HAVE BROKEN NEW GROUND. I DON'T WANT TO SAY THAT MARTY FELDSTEIN IS A PESSIMIST, BUT WHEN HIS TEN-YEAR OLD ASKED HIM, "DADDY, WHAT AM I GOING TO BE WHEN I GROW UP?" MARTY JUST PATTED HER ON THE HEAD AND SAID, "POOR." I THINK THAT IF THE CONGRESS HAS THE COURAGE TO MAKE SIGNIFICANT SPENDING CUTS, WE WILL ENJOY A MUCH STRONGER RECOVERY THAN MARTY'S FORECAST INDICATES, AND NOBODY'S KIDS, NOT EVEN MARTY'S, WILL HAVE TO BE POOR.

WHILE IT IS NOT MY PLACE TO MAKE SPECIFIC RECOMMENDATIONS, I THINK THAT THERE IS JUSTIFICATION FOR IMPOSING FURTHER LIMITATIONS ON THE COST OF LIVING ADJUSTMENTS FOR THE ENTITLEMENT PROGRAMS. OVER THE LAST TEN YEARS, BENEFITS FROM ENTITLEMENT PROGRAMS HAVE RISEN FASTER THAN WAGES. I ALSO BELIEVE THAT THERE IS ROOM FOR FURTHER CUTS IN DEFENSE SPENDING. ADDITIONAL BUDGET CUTS WILL LOWER THE INTEREST CHARGES THAT THE GOVERNMENT MUST PAY AS WELL.

THE MOST IMPORTANT MESSAGE THAT I WANT TO CONVEY TO YOU TODAY IS THAT THE BUDGET DEFICITS SHOULD BE REDUCED BY SPENDING CUTS, NOT BY TAX INCREASES. I KNOW THIS IS EASIER SAID THAN DONE. A FEW YEARS AGO I WORKED FOR SENATOR BENTSEN AS THE EXECUTIVE DIRECTOR OF THE JOINT ECONOMIC COMMITTEE. AT THAT TIME, WE DID

NOT WORRY MUCH ABOUT DEFICITS. IN FACT, ONE OF OUR MAJOR HEADACHES WAS SOMETHING CALLED "SPENDING SHORTFALLS." "SPENDING SHORTFALLS" WERE WHAT YOU GOT WHEN THE FEDERAL GOVERNMENT SPENT LESS THAN IT WAS SUPPOSED TO SPEND, AND, CONSEQUENTLY, THE DEFICIT WAS BELOW THE PROJECTIONS. PROBABLY AT NO TIME IN THE HISTORY OF FISCAL POLICY HAS AN ECONOMIC PROBLEM BEEN CURED AS THOROUGHLY AND RESOUNDINGLY AS THE SHORTFALL PROBLEM OF THE LATE 1970's.

CURING THE CURRENT FISCAL CRISIS IS NOWHERE NEAR AS EASY. AS YOU KNOW, THE AMERICAN BUSINESS CONFERENCE LED THE COALITION OF OVER 150 ASSOCIATIONS AND CORPORATIONS SUPPORTING THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982. THE MEMBERS OF THE AMERICAN BUSINESS CONFERENCE VOTED LAST MARCH TO SUPPORT A TAX INCREASE ON BUSINESS AS PART OF A PACKAGE OF TAX HIKES AND

SPENDING CUTS DESIGNED TO PARE THE DEFICITS. WELL, WE GOT OUR TAX INCREASE, BUT THE SPENDING CUTS WERE PRETTY SLOW IN COMING. NOW, THERE IS TALK OF ADDITIONAL TAX INCREASES, INCLUDING POSTPONING OR ELIMINATING THE THIRD YEAR OF THE PERSONAL TAX CUTS INSTITUTED UNDER THE ECONOMIC RECOVERY TAX ACT OF 1981 OR IMPOSING VARIOUS SURCHARGES ON INDIVIDUAL AND CORPORATE INCOME.

I THINK THAT ANY FURTHER TAX INCREASES AT THIS TIME WOULD BE A SERIOUS ERROR. THE DEFICIT MUST BE REDUCED BY SLICING SPENDING, NOT BY RAISING TAXES. FURTHER INCREASES IN TAXES WOULD PROVIDE JUST AS MUCH OF A THREAT TO THE RECOVERY AS RAPIDLY RISING DEFICITS.

THE INFANT RECOVERY HAS ARRIVED. I SUGGEST THAT WE PASS OUT CIGARS AND THEN GUARANTEE THE RECOVERY A LONG AND PROSPEROUS LIFE BY REDUCING THE PROJECTED FEDERAL DEFICITS THROUGH SPENDING CUTS AND SPENDING CUTS ALONE.

THANK YOU!

Chairman DOMENICI. Mike, would you like to go next?

STATEMENT OF JAMES D. "MIKE" McKEVITT, DIRECTOR OF FEDERAL LIGISLATION, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. MCKEVITT. Chairman Domenici and Senator Exon, I thank you for staying at this late hour. I will make my remarks brief. I am the director of Federal legislation for the National Federation of Independent Business.

As you know, we have over a half a million members, 540,000 across the country, and they hire about 14 million people. And in talking to them as I have over the last several months, I see some crocuses out there or forsythia, maybe a little spring budding in the good moods.

I think our next quarterly economic report coming out in 2 weeks is going to, for the first time in 3 years, show an optimistic mood. I notice, for example, if you were to have attended the homebuilders convention this past month or the Associated Building Contractors, one of the things that I observed at one of those two conventions was the fact that the members were spending more time at the exhibits looking at equipment.

And the question is whether they can afford it, whether they will buy it, whether they will make the jump to do it, but you do see that mood out there. I talked to one of our member automobile dealers in the Washington area the other day and he said he sees things getting better but he said he also sees where we are going to have to have some interest rates come down on installment buying, and we got to have a signal here by June or July or we see some real problems.

I am sure we will see auto sales start to pick up a little bit. You do not see a lot of bright spots in Senator Exon's State with the farm problem out there obviously but I think one thing we need to do is maintain pressure for cutting spending. This is why we joined with the other two business groups 1 week ago, so far as cuts in defense spending as well as social programs.

GIVE SIGNAL TO CREDIT MARKETS NOW

I think we have to do it to give a signal to the credit markets, we really do, Senator. I cannot tell you how many of our members who have hung on through this period but now say we know it is going to be the valley of death if we do not see further easing of interest rates by June. If we do not have that signal from the Congress, and I am glad to hear, Senator, your colleagues on both sides of the aisle today talk about a bipartisan solution because I think we have really come to that point.

I know when I was down in Nashville, Tenn., a couple of weeks ago with Congressmen Albert Gore and Claude Pepper, we did an all-day forum down there to 1,600 members on social security.

And the thing they kept talking about was bipartisan solution. Enough is enough. I think there is a lot of concern about the politics in this country. I think a lot of people got it fed up to here because they realize they are right at the edge, and as a result, I think we have all got to be candid, we must all stop pointing fingers and come to agreement, because I can tell you this.

If you really want to restore jobs, we are the job providers out there in the private sector. As you know, small business provides 56 percent of the private sector jobs, and that is not going to happen unless the right signals will be given to the credit markets.

I am deeply concerned about the previous panel's talking about the $60 billion in additional taxes. I think you share my concern about that, right, Jack?

Mr. ALBERTINE. Yes, sir.

Mr. McKEVITT. That is the essence of what we are talking about. I say this. We have been through a lot of pain already in the last several months. If we do not give a signal to the credit markets now, then all the pain was for nothing.

Thank you.

Chairman DOMENICI. Thank you very much, Mr. McKevitt.

NFIB National Federation of
Independent Business

STATEMENT OF
JAMES D. "MIKE" MCKEVITT
DIRECTOR OF FEDERAL LEGISLATION
NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Before: Senate Budget Committee
Subject: 1984 Budget
Date: February 2, 1983

Mr. Chairman, my name is James D. "Mike" McKevitt, Director of Federal Legislation for the National Federation of Independent Business. On behalf of our more than 500,000 small business members, I thank you for the opportunity to discuss our concerns over the proposed federal budget for 1984.

Concerns over the future course of the economy is the major issue to be faced by the Congress. While progress has been made in combatting inflation and interest rates, the cost in employment and business bankruptcies has been high. Though economic indicators are unanimous in pointing towards recovery, both the rate of recovery and the prospect of a sustained recovery are being jeopardized.

It is for these reasons that the NFIB has joined with the American Business Conference and the National Association of Manufacturers to call upon the President and Congress to cut the projected 1984 budget deficit by 25% exempting no part of the budget from reduction.

IF PROGRESS TOWARDS REDUCING THE FEDERAL DEFICIT IS NOT MADE OVER THE NEXT SEVERAL YEARS, THE LONG AWAITED ECONOMIC RECOVERY WILL BE HALTED IN ITS TRACKS. THIS COULD OCCUR BECAUSE FINANCIAL MARKETS MAY REMAIN SKITTISH ABOUT LONG-TERM RATES OF INTEREST, WHICH, IF MAINTAINED AT CURRENT LEVELS, WILL CLOSE OFF MOST FINANCING OF LONG-TERM PROJECTS. A WORSE POSSIBILITY IS THAT THE FEAR OF A NEW ROUND OF INFLATION MAY CAUSE CREDIT MARKETS TO BID UP INTEREST RATES TO THE INSANE LEVELS OF A YEAR AGO.

OF MAJOR IMPORTANCE TO NFIB IS THAT REDUCTION IN BUDGET DEFICITS BE ACHIEVED BY CUTS IN FEDERAL SPENDING WITHOUT ANY ADDITIONAL INCREASES IN TAXES. THIS POINT IS OF PRIME IMPORTANCE TO NFIB MEMBERS FOR SEVERAL REASONS.

ECONOMIC CONDITION OF SMALL BUSINESS

THE MOST RECENT QUARTERLY ECONOMIC REPORT FOR SMALL BUSINESS (OCTOBER, 1982) FINDS SMALL BUSINESS EMPLOYMENT AND INDICES OF SALES AND EARNINGS AT VERY LOW LEVELS. INVENTORY LIQUIDATION AND SALES PROBABLY BOTTOMED IN THE LAST QUARTER OF 1982, WHICH ARE POSITIVE SIGNS. HOWEVER, INTEREST RATES THOUGH DECLINING STILL TOO HIGH TO ALLOW FOR ANY SUSTAINED ECONOMIC RECOVERY IN SMALL BUSINESS.

UNEMPLOYMENT CONTINUES TO MIRROR THE DEPTHS OF THE RECESSION; PROSPECTS FOR A RAPID RECOVERY IN JOBS ARE LOW. ONLY 9% OF ALL SMALL FIRMS REPORTED CURRENT UNFILLED OPENINGS--VIRTUALLY ALL FOR SKILLED POSITIONS. WHAT IMPACT HIGHER FEDERAL UNEMPLOYMENT TAXES OR SOCIAL

SECURITY TAXES WILL HAVE ON EMPLOYMENT IS UNCLEAR AT THIS TIME, BUT IS FELT TO BE A MAJOR INHIBITING FACTOR AGAINST NEW EMPLOYMENT.

SPENDING CUTS NOT TAX INCREASES

THE IMPORTANCE OF REDUCING THE SIZE OF THE BUDGET DEFICIT IS PARAMOUNT, BUT IT IS ALSO IMPORTANT THAT THIS REDUCTION BE ACCOMPLISHED THROUGH SPENDING CUTS AND NOT THROUGH TAX INCREASES. NEW TAX INCREASES FOR SMALL BUSINESS, ADDED TO THE 1982 TAX INCREASES AND PROPOSED SOCIAL SECURITY TAX INCREASES, WILL PLACE SO HEAVY A BURDEN ON SMALL FIRMS THAT NEW EMPLOYMENT AND REHIRINGS MAY BE LOST. THIS POINT IS BEST ILLUSTRATED BY A 1980 REVIEW OF TAX BURDENS WHICH REVEALED THAT OVER 70% OF THE TOTAL TAX BURDEN FOR A SERIES OF HYPOTHETICAL, ALTHOUGH WE THINK TYPICAL, SMALL BUSINESSES WERE ATTRIBUTABLE TO FEDERAL AND STATE REQUIREMENTS RELATED TO LABOR BASED TAXES (SOCIAL SECURITY TAXES, UNEMPLOYMENT COMPENSATION TAXES, AND WORKMEN'S COMPENSATION TAXES).1/ IMAGINE THE IMPACT ON THE MAJOR PRODUCTIVE ASSET OF SMALL FIRMS, I.E. LABOR, FROM A NEW ROUND OF TAX INCREASES.

INTEREST RATES

THE PRESIDENT'S BUDGET REVEALS THAT IN 1984 THE FEDERAL DEFICIT WILL ABSORB 94% OF PRIVATE SAVINGS. THIS LEVEL IS EXTREMELY

1/ RELATIVE BURDEN OF FEDERAL STATE & LOCAL TAXES ON SMALL BUSINESS. (WASHINGTON, DC: TOUCHE ROSS & CO., 1981).

DANGEROUS AND MAY HAVE SEVERAL EFFECTS ON THE ECONOMY, EVEN IN AN ANEMIC RECOVERY:

1) CREDIT MARKETS WILL REMAIN SUFFICIENTLY NERVOUS, DESPITE OPTIMISTIC PROJECTIONS. THEREFORE, LONG-TERM FINANCING WILL REMAIN DIFFICULT FOR SMALL BUSINESS.

2) SINCE LONG-TERM FINANCING PROJECTS CANNOT BE STARTED, ANY RECOVERY WILL TAKE LONGER AND WILL BE SLOWER THAN ANYONE WANTS. THIS CAN OCCUR BECAUSE FITFUL INCREASES IN DEMAND FOR GOODS WILL LOWER NEW PRODUCTION AND MANUFACTURING GOALS. WITH SO MUCH EXCESS INDUSTRIAL CAPACITY, PURCHASES OF NEW, MORE MODERN MACHINERY IS SIMPLY NOT COST EFFECTIVE.

A STEADY REDUCTION IN GOVERNMENT SPENDING AS A SHARE OF GNP WITHOUT ANY NEW TAXES WILL SEND THE PROPER SIGNAL TO WALL STREET AND THE CREDIT MARKETS, AND WILL BUILD THE NECESSARY CONFIDENCE IN A LONG-TERM RECOVERY.

CONCLUSION

THE PRESIDENT'S BUDGET PROPOSAL IS A REALISTIC STARTING POINT FOR CONSIDERING CHANGES IN FEDERAL SPENDING POLICIES. HOWEVER, WE WOULD STRONGLY ENCOURAGE YOU TO GO FURTHER IN CUTTING FEDERAL SPENDING IN ALL CATEGORIES.

THE COMMON GOALS OF OUR MEMBERSHIPS AND THE AMERICAN PUBLIC ARE: LOWER INTEREST RATES, ESPECIALLY IN LONG-TERM CREDIT MARKETS WHICH HAVE BEEN EFFECTIVELY SHUT DOWN TO SMALLER FIRMS; SUSTAINED ECONOMIC GROWTH SO AMERICAN WORKERS CAN BE PUT BACK TO WORK; AND LOW RATES OF INFLATION SO THAT FUTURE ECONOMIC GAINS ARE REAL AND NOT ERODED.

Chairman DOMENICI. Mr. Huard?

STATEMENT OF PAUL E. HUARD, VICE PRESENT OF THE TAXATION AND FISCAL POLICY DEPARTMENT, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. HUARD. Thank you, Senator.

My name is Paul Huard. I am vice president of taxation and fiscal policy for the National Association of Manufacturers. NAM represents over 12,000 member firms who account for nearly 80 percent of the Nation's industrial output and 85 percent of the Nation's industrial work force.

Obviously, the reason the three of us are here is we did join together and make a common recommendation so I will introduce my formal statement for the record, but I am not going to repeat what Jack and Mike have said.

GLARING IMBALANCE IN DEFENSE SPENDING

I would like to make several comments. I think that I agree with the chairman that the President's budget this year is different from the previous budgets he has submitted. I think he is a lot, if you look at it really, a lot closer than most people realize to what Mr. Peterson and his group are suggesting.

He is frankly fairly close to what we have suggested. We suggested cuts of up to $50 billion in the fiscal year 1984 budget. He has come up with about $42 billion from the baseline of $231 billion.

I would observe that the one area where there is frankly a glaring imbalance is in defense spending. I think at a time when most of the other elements of the budget are being held to either no growth or negative growth after adustment for inflation, there is some serious question as to whether the defense budget ought to grow at a real rate of nearly 10 percent, and we would suggest that a good part of additional cuts that could be made to reach the target goal we have suggested probably ought to come out of the defense area.

I would associate myself with Jack's comments and Mike's on taxes. I do not think fiscal year 1984 and fiscal year 1985 are the times for new taxes in the orders of magnitude that the Peterson group is suggesting particularly when we might have an economic recovery that may prove to be somewhat fragile.

SKEPTICAL OF VIABILITY OF STANDBY TAXES

We have not taken a formal position on standby taxes. I am a little skeptical, as I guess a lot of people are, of the viability of standby taxes, and I would think that Congress should more appropriately look at taxes 1 year at a time when they are going through the budget process and not use what may be, well, it is probably a little much to call it blue smoke and mirrors, but my experience with budget projections is the further out you go the less likely you are to be in any way accurate, even when you are only talking about the current fiscal year.

We are in a situation now where we projected $100 billion for fiscal year 1983 and we are going to have double that so that I think it is probably questionable whether you should play that kind of game as far out as 1986, 1987 and 1988, with contingent tax increases on the order of magnitude of $50 billion.

Again, we are studying this, and we probably will take a more definite position, but I would have some grave reservations about standby taxes as a way out of this. I think that is about all I have, Mr. Chairman.

Chairman DOMENICI. Thank you very much, Mr. HUARD.

National Association of Manufacturers

TESTIMONY SUBMITTED FOR THE RECORD

BY

PAUL R. HUARD

ON

THE FY 1984 BUDGET PROPOSALS

ON BEHALF OF

THE NATIONAL ASSOCIATION OF MANUFACTURERS

SENATE BUDGET COMMITTEE

FEBRUARY 2, 1983

1776 F Street, N.W. • Washington, D.C. 20006 • (202) 626-3700

INTRODUCTION

I am Paul R. Huard, Vice-President for Taxation and Fiscal Policy of the National Association of Manufacturers (NAM). The National Association of Manufacturers welcomes this opportunity to present our views on the proposed FY 1984 budget. Our recommendations are essentially the same as those we advanced at our press conference of January 18. In our view, the proposed deficit is still excessively large. The deficit should be reduced by up to $58 billion from the level that would prevail in FY 1984 under current law. The Administration has already proposed $42 billion in cuts from current law; in this respect, we recommend an additional $16 billion in reduced spending, which should include cuts in defense. In this statement we present an executive summary of our conclusions and recommendations, followed by a more detailed analysis of the budget and its economic significance. We then list possible areas that should be the subject for additional spending cuts.

EXECUTIVE SUMMARY

1. The budget contains any number of provisions that we support, in particular extensive cuts in non-defense spending. The cuts are sufficient to put deficits on a declining trend in real terms although deficits remain exceedingly high by postwar standards. We also commend the Administration for undertaking no further tax increases at the present time. The FY 1984 budget therefore represents a substantial improvement over the budgets that would take place under present law.

2. However, the budget as presented has a series of drawbacks. Paramount is the magnitude of the deficit, which surpasses 5% of GNP until FY 1986. This will create considerable pressure on capital markets, enhancing the probability of future increases in interest rates. Moreover, while the economic assumptions on which the budget is based are quite realistic in the near term, the possibility of another recession in the mid-1980s makes the predictions for the out-years somewhat more tenuous, and could raise the future deficit at this time. Finally, the budget does not resolve the fundamental conflict between fiscal policies which have been excessively expansionist and monetary policies which have been essentially restrictive which has been in evidence for the past three years.

3. For this reason, we recommend a series of spending cuts of up to $58 billion from current law. Such cuts could be drawn from the program areas suggested by the Administration, plus additional defense spending cuts of up to $16 billion.

4. These cuts will bring the full-employment budget into approximate balance. Such a move would go quite far in redressing the asymmetry between fiscal and monetary policy. It would entail considerably less pressure on interest rates through alleviation of the severe "crowding out" problem in credit markets and in this sense would be more commensurate with a stronger economic recovery and greater financial stability.

I. THE FY 1984 BUDGET: GENERAL OBSERVATIONS

Through extensive cuts in non-defense spending, the FY 1984 establishes a gradual downward trajectory for the Federal deficit. This is accomplished primarily through cuts in domestic non-defense spending. Total spending is projected to increase by 0.2% in real terms in FY 1984, followed by inflation-adjusted increases of 2.8% and 2.6% during the next two fiscal years. Of the FY 1984 increase, however, defense spending will increase 10.0% in real terms, while non-defense spending will decline -2.9%. We view the cuts in non-defense spending as a significant positive step from the perspective of reducing Federal expenditure, although we believe that these areas can be cut still further. By comparison, under current law, the deficit would reach $231 billion in FY 1984 and $271 billion in FY 1986; under the provisions of the proposed budget, the deficit would stand at $189 billlion in FY 1984 and $148 billion in FY 1986, or 5.4% of GNP and 3.6% of GNP respectively. Therefore, in the long term, the Federal deficit would decline in real terms under the new budgetary proposals.

However, it would remain unacceptably high from the standpoint of easing congestion in capital markets and restoring greater financial stability. After reaching an estimated 6.5% of GNP in FY 1983, the deficit is projected to stand at 5.4% of GNP in FY 1984 and 5.1% in FY 1985, not reaching 3.6% of GNP, equal to its level of FY 1982, until FY 1986. When off-budget items are added, the combined on and off-budget deficit reaches 5.8% of GNP in FY 1984, 5.4% in FY 1985 and 3.8% in FY 1986. A deficit of this magnitude has serious implications for financial stability. Because the trajectory of monetary policy during the next few years is projected to be essentially non-accommodative, notwithstanding some recent loosening, the proposed budgets do not resolve the problem of the fundamental asymmetry between monetary and fiscal policy. Since 1980, the configuration of demand management policy has been characterized by fiscal policies that have been highly expansionist in conjunction with monetary policies which have remained restrictive. The net effect has been recessionary since the fiscal stimulus has been outweighed by monetary restraint. Nevertheless, the effect of the deficits has been to entail considerable pressure on credit markets and raise interest rates.

The deficits projected for FY 1984 and beyond do not resolve this problem, and instead suggest that it wil continue to be visible over the next few years. Several indicators confirm that the problem of congestion in capital markets will not be substantially mitigated during the next few years. The share of Federal debt held by the public is projected to rise from 30% of GNP in FY 1982 to 38.6% in FY 1984 and surpass 40% thereafter. Federal borrowing, which reached 48.9% of all funds raised in capital markets in FY 1982 (when the deficit was 3.6% of GNP) is projected to surpass 50% of all funds raised during the next two fiscal years, as well as in FY 1983. Therefore, even assuming a somewhat less restrictive trajectory for monetary policy than during the previous two years, there remains considerable danger that Federal credit requirements will constitute a source of upward pressure on interest rates, particularly in late 1983 when greater economic activity will be associated with cyclical increases in private sector credit demand.

Moreover, while under the Administration's economic assumptions the budget deficit will decline to 3.6% of GNP in FY 1986, it is not clear to what degree the economic projections for future years beyond FY 1986 can be realized. The Administration is assuming real GNP growth of 1.4% in 1983, followed by growth rates of 4% sustained over the next five years of a six year forecast horizon. We consider the short term forecast to be substantially correct, for calendar years 1983 to 1985. However, the long term forecast exhibits an unrealistic absence of cyclic behavior. Given a postwar business cycle averaging 3 to 5 years in length, the next major recession is likely to emerge between 1986 and 1987, and could emerge as early as 1984-85 in the event of another rise in interest rates. In this eventuality, the ability to achieve lower deficits during the mid-1980s, as projected in these budgetary proposals, must be regarded with considerable caution.

II. THE WIDER SIGNIFICANCE OF DEFICITS

The emergence of large deficits during the past few years and the projection of sustained large deficits through the latter part of the decade has brought into sharp relief a series of questions about the wider implications of fiscal policy. While deficits in the range of up to 2% of GNP do not give any evidence of being destabilizing, substantially larger deficits such as those anticipated for 1983-84 may be associated with upward pressure on interest rates, or higher inflation. Secondary implications of large deficits may include interference with monetary control and maldistribution of resources. Since the relative magnitudes of these effects are of considerable importance in the development of fiscal policies more commensurate with economic stability, it may be of interest to examine each of these arguments in greater detail.

DEFICITS, MONEY CREATION AND INFLATION

If fiscal deficits are financed through additional money creation (i.e., if the Federal Reserve creates new bank reserves through purchases of government debt), the resulting increases in the money supply will yield increases in aggregate demand. Therefore, if sustained until sufficiently late in the business cycle, large deficits may destabilize the economy and contribute to the emergence of inflationary pressure. This was clearly in evidence during the late 1960s when the Vietnam War deficits were financed through excess money creation.

However, this does not appear to have taken place during the 1970s to any significant degree. During the reflationary period 1971-73, the Federal deficit averaged 1.8% of GNP while the money supply (M1) averaged 7.1% growth per year, surpassing 9% growth in 1972; in other words, monetary policy was considerably more expansive than what would have been implied by the need to finance deficits. Similarly, during the second reflationary cycle of the late 1970s, 1976-79, the budget deficit declined consistently from 4.5% of GNP in 1975 to 0.9% in 1979 while the growth rate of M1 accelerated to an average of over 8%. In other words, the reflationary periods during the 1970s were predominantly monetary rather than fiscal in origin, and monetary expansion was fundamentally a result of attempts to provide easier credit to the private sector rather than accommodation of government borrowing. At the same time, periods of large deficits during the mid-1970s and 1980-83 have characteristically been associated with restrictive monetary policy. The large deficit of 1975 was not fully accommodated by the Federal Reserve. The increasing deficits of 1981-83 have been accompanied by a prolonged phase of restrictive monetary conditions.

In other words, the alleged linkages between deficits and money creation cannot be substantiated during the 1970s. The period in which fiscal and monetary policy underwent synchronized expansion during the Vietnam War has been superseded by one in which fiscal and monetary policy have frequently moved in divergent directions. We therefore find insufficient grounds for assuming that the deficits will raise the inflation rate. Instead, we are substantially in agreement with the Administration's economic forecast that the inflation rate will continue to decelerate in 1983-84, eventually stabilizing in the 4% range.

DEFICITS AND INTEREST RATES

In situations where private sector demand for credit is high or savings are small relative to private and public sector demand for credit, large deficits, to the extent they are not financed through money creation, will tend to "crowd out" the private sector in credit markets, leading to higher interest rates.

There is considerable evidence to indicate that this "crowding out" process has taken place in an exacerbated form since 1980. Specifically, the ratio of the Federal deficit to private savings increased from 3.5% in 1979 to 15.2% in 1980. Although this ratio declined to 13.7% in 1981, in 1982-84 it is projected to rise to a range of 45% to 50%. One indication of the degree to which this has resulted in added pressure in capital markets is provided by the ratio of total Federal borrowing to loanable funds raised. This ratio reached peak levels of 37.2% and 40.6% in FY 1975-76, when large deficits were only partially accommodated. Thereafter, as deficits declined and monetary policy became more reflationary, the ratio declined to 25.5% in FY 1977 and 18.9% in FY 1979. However, the shift in the mix of policy to fiscal expansion coupled with monetary restriction led to an increase in this ratio to 33.7% in FY 1980, 33.3% in FY 1981 and 48.9% in FY 1982. In FY 1984, Federal participation in capital markets is projected to be in the range of 55% of all funds raised.

In essence, alternative indicators of the degree to which increased Federal borrowing has absorbed loanable funds support the hypothesis that large Federal deficits since 1980 have led to severe congestion in credit markets which in turn has placed considerable upward pressure on interest rates. In this respect, the asymmetry between tight money and highly expansive fiscal policy has clearly exacerbated increases in interest rates through flow of funds mechanisms.

OTHER IMPLICATIONS OF LARGE DEFICITS

Destabilization of Financial Markets Even if deficits are not necessarily associated with accelerating inflation, they may destabilize financial markets in other ways.

First, if deficits lead to a rise in inflation expectations--in other words if financial executives expect that deficits will be ratified by monetary expansion, financial executives may raise the "expectations premium" on interest rates. This appears to have taken place in 1980-81. Financial decision-makers, evidently concerned that the Federal Reserve would not be able to maintain its tight money policies in the face of the large deficits projected for the mid-1980s, raised interest rates in order to protect their real rates of return on loans from the possibility of an increase in inflation.

A further dimension of the expectations problem has had to do with expectations of future interest rates. Assuming expectations to be rational, financial executives will expect that large deficits in conjunction with tight money imply continued upward pressure on interest rates; consequently, they will not lower interest rates in the short term, since this would not guarantee the optimal rate of return on loans. In addition, a high interest rate environment increases the risk inherent in lending to the private sector, since businesses with cash-flow problems may not be able to maintain interest payments. Consequently, financial executives may add on a "risk premium" to the interest rate charged on loans.

Maldistribution of Resources As the ratio of the public sector to GNP rises, the effect is to increasingly redistribute capital and resources away from private industry and into public sector services. Since services exhibit lower productivity growth rates than manufacturing industry, the result may be a drag on the overall productivity growth of the economy. At the very least, there is an "opportunity cost" in excessive government spending--resources allocated to the public sector cannot be used in private investment. This effect would tend to emerge, however, irrespective of whether the increase in the public sector is financed through taxes or through deficit spending. To the degree that the increase in the ratio of Federal government to GNP in the United States has typically involved deficits, however, this represents a claim on available credit. In many industries, such as housing, autos and consumer durables, the final status of aggregate demand is critically dependent on the cost and availability of long term credit. For this reason, decreased credit availability resulting from higher government borrowing will lead to declining demand and contractions in output in these industries.

Interference With Monetary Policy Large deficits can interfere with the conduct of monetary policy, even when the issue of accommodating deficits is not at stake. For instance, when monetary policy is geared toward reducing inflation, as it has been since late 1979, large deficits may exacerbate the declines in production and employment by raising interest rates. Conversely, if deficits were smaller during periods of monetary restriction, the effects of tight money may be less onerous for the private sector. A further dimension of this issue has to do with expectations. If large deficits raise inflation expectations, monetary policy may have to become more restrictive in order to convince financial markets of the credibility of the anti-inflationary effort. There is some evidence that this took place in 1981: the Federal Reserve consistently undershot its monetary targets, apparently in an attempt to convince financial markets that it would not monetize Federal deficits.

III. RECOMMENDATIONS FOR FISCAL POLICY

Taking account of these considerations, we recommend a series of additional spending reductions aimed at the development of a fiscal policy more commensurate with a stable growth path for the economy. At the present time, the most urgent priority for fiscal policy is to reduce the Federal deficits projected for FY 1984 and beyond. This will mitigate the current asymmetry between fiscal and monetary policy, leading to a configuration of demand management more compatible with economic stability. It will also partially alleviate the crowding out process in credit markets, reducing the danger of further increases in interest rates. In essence therefore, the posture of fiscal policy, which since 1980 has been excessively expansionist, should be given a more restrictive orientation.

However, in this respect, given the sluggishness of the economic recovery projected for 1983-84, fiscal policy should not be allowed to become excessively restrictive, for instance through major tax increases. In this respect, we commend the Administration for undertaking no new tax increases in the budget proposals for FY 1984. Raising taxes during a period of protracted economic slack would have entailed a serious risk of further undermining a recovery which is already projected to be very weak by historical standards. In particular, tax increases on business, such as the modifications to ACRS passed under TEFRA in 1982 would further reduce the incentives for capital investment initially undertaken under ERTA in 1981, incentives which have also been compromised by the adverse economic environment. For this reason, we believe that the most appropriate course for fiscal policy would consist of phased reductions in Federal outlays aimed at reducing deficits over the next few years.

As a target level for expenditure reductions in FY 1984, we recommend that outlays be cut up to $58 billion from current law. Achievement of this amount would represent a reduction of 25% in the baseline deficit projected under current law. This figure is based on the need to bring the full-employment budget into surplus. Under current law, the full-employment budget will show a deficit of approximately $45 to $55 billion in FY 1984. Initially developed in the 1950s, the concept of the full employment budget provides one measure of the cyclically adjusted impact of fiscal policy on aggregate demand, since the full-employment deficit represents the additional stimulus provided by the deficit when the unemployment rate is at its natural or equilibrium level. In this sense, by bringing the full-employment budget into surplus, the asymmetry between fiscal and monetary policy can be significantly reduced, albeit not eliminated altogether.

While we support the cuts proposed by the Administration, we believe that they do not go quite far enough from the standpoint of achieving the spending targets we have described. Instead, our basic recommendation is that spending reductions be achieved which will reduce outlays by the specified target figure of $58 billion.

In our earlier resolution, we recommended that the deficit for FY84 be reduced by 25% or approximately $58 billion using the $231 billion baseline included in the President's budget. As we released our proposal prior to the President's budget message, we based our numbers on a somewhat less pessimistic deficit and therefore were suggesting about $50 billion in spending cuts.

In our proposal for FY84 spending cuts, we recommended defense cuts of up to $23 billion, cuts in entitlements (including Social Security) of up to $15 billion and cuts in discretionary non-defense spending of up to $15 billion. These cuts add up to a maximum of $53 billion and would have to be broadened somewhat to achieve our new suggested target of $58 billion in outlay reductions.

We are pleased to note that, in all areas save one, the President's budget proposes cuts in the same order of magnitude that we have suggested. The one glaring exception is defense spending, where the Administration has proposed outlay reductions of only $8 billion.

In our view, the sacrifices entailed in spending cuts should be spread equitably across all areas of the Federal budget with no type of spending bein immune from painful reductions. The President's proposal, on the other hand, would permit real growth in defense spending of nearly 10% while the remainder of the budget essentially would be frozen (or even reduced) after accounting for inflation. We do not think an imbalance of such proportion should be permitted, and therefore recommend that the bulk of any additional outlay reductions over the $42 billion recommended by the Administration be taken from the defense area.

V. CONCLUSIONS

In conclusion, our evaluation of the budgetary proposals is that the cuts in non-defense spending are desirable from the standpoint of reducing the deficit and placing the long-term deficits projected for future fiscal years on a declining trend. However, these deficits remain atypically high by postwar standards, and do not resolve the inherent conflict between a fiscal policy that is unnecessarily expansionist and monetary policies which remain essentially restrictive. Since the Federal Reserve is not expected to accommodate the expanded Federal government borrowing requirement, the deficits will continue to create pressure in credit markets: the ratio of federal borrowing to funds raised in capital markets, which surpassed 48% in FY 1982 when the federal deficit stood at 3.6% of GNP, is projected to surpass 50% until FY 1986. Moreover, the prospects for reducing the deficit after FY 1986 will be critically dependent on achieving sustained economic growth at this time; another recession, emerging in 1986-87, which would be commensurate with normal postwar business cycle behavior, would further raise the deficit during the latter half of the decade.

Based on these considerations, NAM recommends spending reductions of up to $58 billion from current law representing a 25% reduction in the baseline deficit proposal of $231 billion. Approximately $42 billion of such cuts have already been proposed by the President. We believe an additional $16 billion can be found, primarily in the area of defense spending. The objective should be to bring the full-employment budget into equilibrium in order to mitigate the asymmetry between fiscal and monetary policy.

MAJOR CHANGES IN TAX LAWS OPPOSED

Chairman DOMENICI. I would assume, based upon your testimony, that if you are concerned about the propriety of a 1985 or a 1986 tax in the nature of that recommended by the Peterson group or the President's contingent one, that you would be opposed to any major change in tax laws to raise revenue in the year 1983 or 1984, Would that be a fair statement?

Mr. ALBERTINE. Yes, sir.

Mr. MCKEVITT. That is right. Let me just point out, Mr. Chairman, that in the years 1981 through 1985 we will get a payroll tax increase, and 70 percent of our members now in NFIB pay more in payroll taxes than they do in income tax.

It really should be changed to call it a job tax instead of a payroll tax, because that is in effect what it is, and all you are going to do is discourage the creation of more jobs.

Chairman DOMENICI. There is a suggestion around, for instance, that we pick up $31 billion in deficit reduction tax increases by deferring the third year of the tax cut which would occur in 1983 partially and then in total in 1984.

I assume, on your statement, that you would not look with favor upon that for economic reasons?

Mr. ALBERTINE. Yes, sir. There are two aspects of that that are important. One is I think we are going to need the stimulus of that, to keep the recovery going.

But the second part of my answer to that would be that there is a proposal around to cap the third year. In fact, that does not raise an awful lot of revenue, but what it does do is, in my judgment, reduce the savings pool that we are talking about. To an extent a cap may be desirable from a social point of view, but from an economic point of view, a cap has the effect of reducing savings by about as much as the revenue which it generates to the Federal Government. You will get no net benefit on interest rates as a result.

Chairman DOMENICI. Paul, I would imagine that a number of your members——

Mr. MCKEVITT. May I answer that last question?

Chairman DOMENICI. Of course.

Mr. MCKEVITT. The tax bill passed by the last Congress, even though a lot of it was geared to small business, much of it we could not avail ourselves of because of the economic situation during the past 2 years.

The one provision which would be of benefit to us is the individual rate cut so for such reason when we need a shot in the arm, and if this takes place this year, would really be the first time we would see a benefit from it, we would be opposed to it.

ADDITIONAL SAVINGS THROUGH DEFENSE RESTRAINT

Chairman **DOMENICI**. One last question. Paul, I would assume many of your members and certainly some of yours, Mike, but perhaps less, involve themselves in military contracts; am I correct?

Mr. **HUARD**. That is correct.

Chairman **DOMENICI**. And nonetheless, it is your recommendation that some additional savings be realized through defense restraint?

Mr. **HUARD**. That is correct, and that is a recommendation we make in full awareness of the fact that our members will get less procurement dollars as a result. It is based on a feeling that large spending reductions are just essential to bring the deficits down, and the only way we see being able to get that kind of spending reduction on the bipartisan basis that is required is if the pain is spread across all sectors of the budget including the defense budget. You just cannot hold any area sacrosanct or sacred.

Mr. **MCKEVITT**. Senator Domenici, as you know, since you were the author of this program many years ago, we started doing town meetings in your State of New Mexico, and we have kept it up with various Members of the House and Senate since then.

Last year, I did them, for example, with Senator Chiles and Senator Bentson, Senator Melcher, Senator Mitchell, and Senator Gorton from the State of Washington was one.

One of the interesting things that came out of our meetings up there in the Seattle area and Bellevue and Bremerton area was the fact that many of our members there were defense subcontractors, and they were candidly getting up in the audience, these were audiences of 300, 400 and 500 strong, pointing out overspending by defense and where it should be curtailed.

Mr. **ALBERTINE**. It is also true for our high technology defense firms as well, Senator.

Chairman **DOMENICI**. Senator Exon?

Senator **EXON**. Do you want to go?

Senator **RIEGLE**. Well, you have been waiting all day long.

Senator **EXON**. That is all right.

Senator **RIEGLE**. First of all, I will be very brief. I want to welcome my former colleague and friend, Mike McKevitt particularly.

Mr. **MCKEVITT**. Thank you, Senator Riegle.

Senator **RIEGLE**. I notice two things you say in your statement, Mike. One is that only 9 percent of all the small firms reported current unfilled openings at the present time and virtually all of those for skilled positions.

I think when we look at the scale of the unemployment problem in the country and see that things are so anemic on the small business side that only 9 percent of your folks have job openings and all of them or virtually all of them are for skilled people, I think that really helps illustrate the structural nature of this problem and how deep it cuts.

DIRECTING CREDIT TO SMALL BUSINESS

The other thing related to that was when you point out here that the President's budget reveals that in 1984 the Federal deficit will absorb 94 percent of private savings, and I just think we are not going to get going if that continues to be the case.

Mr. McKEVITT. You put your finger on it, Senator Riegle, and if that is the case, you know, that is where we meet payrolls, where we hire more people, where we buy new equipment, and if 94 percent of it is going in that direction, we are in real trouble.

Senator RIEGLE. Let me ask you this. With the merger mania that has been going on between big firms, a lot of corporate takeovers, a lot of multibillion-dollar lines of credit being set aside and used for that and so forth, I am just wondering, given the nature of how the recession has run, should we be thinking, and I know this is not the committee that has the jurisdiction directly, but should we as a Senate be thinking about some way to see that maybe we need a new credit facility or somehow, someway to make sure that some fair share of what credit is available is making its way to small business, recognizing that most of the jobs that are created in this country, when they are created, are created by smaller businesses.

It seems to me that the way credit works in the country, the small businesses tend to stand last in line in getting their hands on what credit there is, especially when there is a credit shortage.

I am just wondering if we are not getting to a point here where we need to think about the question of making sure that there is enough credit which you can sort of think of as oxygen making its way through to that sector of the private sector, to the small business sector.

Mr. McKEVITT. Well, let me make sort of a two-part answer to your question. No. 1, in the field of conglomerate mergers, that is another one that crowds us out of money markets. It is not the Federal Government, but it is the conglomerate mergers that do it as well and so it is very difficult for us to get our hands on money when you are competing against both Uncle Sam and also the merger aspect.

As you may recall, we supported Senator Kennedy in his bill in the Congress before last so far as the merger problem was concerned, and so we do have a concern about that.

In answering the second part or more specifically honing in on your question of directing credit to small business, one of the problems you get, Senator Riegle, is getting the horse to water but making it drink.

And the problem is getting the banker like for example I talked to the SBA administrator a couple weeks ago about some new ideas in financing out of SBA, but see, only one-tenth of 1 percent of our members get SBA loans because they say it is too much bureaucracy, and only half of our members get bank loans. The rest of them get second deeds on their home, borrow from relatives, that type of thing.

So it is a matter of opening it, the credit avenues in that direction. I wish we could figure out some way. Maybe we should chat about that.

Senator **Riegle**. I would like to.

Mr. **McKevitt**. Because I have some ideas, and I do not want to take this time now this late in the day, but I would like to go over some of those ideas with you on how we can make money more available to small business.

Senator **Riegle**. Good. Let us do that.

Thank you, Mr. Chairman.

Chairman **Domenici**. Senator Kasten?

DEBT EQUITY FINANCING

Senator **Kasten**. Mike, there is a portion of our economy that is experiencing real growth these days. It is the high-tech, high-risk, new-venture sector. What can we in Congress be doing to help this sector? Or, maybe better put, what can we do to get Government out of the way and let this sector work on its own?

Mr. **McKevitt**. Well, one thing, of course, thanks to many of you in the past Congress, we got this provision through on setasides which would be some incentive so far as Government R&D is concerned on high tech.

I think maybe I would behoove all of you and your colleagues to read the book Megatrends. I think this gives come interesting insight into the it, John Nesbitt's new book on the way the country is heading, if not the world.

Their biggest problem, I think one of their biggest problems, obviously, is money, venture capital. One of the things, if I can just touch on this, and I do not want to get into long answer here, but it is debt equity financing, Senator Kasten.

We have tried to sell Treasury on this over the last two administrations, this administration and the last administration. All the different small business groups and groups like the chamber of commerce and NAM and others have agreed on a joint thrust on a simplified approach to debt equity financing, a simple test, because one of the problems you get is in high tech you borrow a lot of money that exceeds, you know, your assets by far so they say, well, you have to treat that, you know, as a stockholder, rather as a loan and you cannot deduct the interest. That is a discouragement.

So that is another factor of it. There is any number of ways to do it, but one would be to simplify it so far as getting at debt equity capital is concerned. Obviously, simplifying the regs, and of course, the other problem you have from the high tech aspect is getting people who are skilled, and the problem you have sometimes, as John Nesbitt points out in his book is skilled being able to read and write. It is a tremendous problem they have in getting people into that.

Mr. **Albertine**. Senator, may I comment on that?

Senator **Kasten**. I would like for each of you to comment if you have something to add.

REDUCE CORPORATE RATES ACROSS THE BOARD

Mr. **Albertine**. With respect to that issue, the reduction in capital gains rate is very, very helpful, I think, to new startups, and from what I am told from people who are now midsized companies that are in the capital venture business, there is an enormous amount of venture capital around.

That proposal was an excellent one and ought to be retained. We, at the American Business Conference, are about to release a study in March on effective tax rates among various kinds of companies in America.

It turns out that if you look at high value added companies, those that are to $50, $100 million, $200 million, or $300 million, the effective tax rates of those companies are significantly higher than the effective tax rates of either the large Fortune 100 or of small business.

The reason for that is that aspects Of the tax code, like investment tax credits and accelerated depreciation, are really not terribly powerful to a high value added company of significant size, and things like the corporate surtax exemption obviously are not very important.

So one of the things that I think that the Congress ought to do is take the advice of Professor Harberger at the University of Chicago, who recently said that the existence of the corporate income tax is as much a barrier to economic growth as the uneven application of the corporate income tax.

I think it is a very interesting and important point, that the administration is proposing a contingency tax. My understanding, at least at the preliminary drafting stage, is that that tax is going to be applied on 5 percent of taxable income.

The effect of that will be to raise the effective tax rates of those firms that now have the highest effective tax rates. That is a mechanism for doing what the tax code does—which is penalize the winners and subsidizes the losers.

So I would urge you all to take a strong look at simplifying the corporate side as well as the personal side of the tax code, perhaps take a look at some of the exemptions and exclusions, including the R & D tax credit, and maybe just look at reducing corporate rates across the board.

Senator KASTEN. Do you have anything to add to that?

FEAR OF ANTITRUST LAWS

Mr. HUARD. Well, I think there are a number of areas which would be very helpful outside the area of tax policy, allthough I think tax policy is significant. We have gotten a lot of input from our members on the negative effects that they feel.

Part of this problem may be nothing more than perception, but it relates to the antitrust laws. There is a lot of unwillingness amongst a lot of our high tech members to engage in joint ventures on an R & D nature—joint research—primarily due to fear of the antitrust laws.

Now, this may be due to excessive caution in corporate legal departments. It may be due to a lack of flexibility at the Justice Department. We are in the process of examining the issue and trying to see if we can determine or isolate what the principal aspects of the problem are.

But I would suggest, even though this is not a budgetary matter or even a tax matter, that you look at the application of antitrust policy to joint research and development projects, which can be, you know, very helpful. They can lead to the development of products which, frankly, a single company could not afford to develop, and there is some evidence that we could be doing a lot more of it, and we are not doing it because of the antitrust laws. I think that is one significant area that bears some examination.

Senator KASTEN. Thank you.

Senator Exon?

Senator EXON. Gentlemen, thank you very much for coming. I have been here all day today except for the first hour of the Stockman testimony this morning, and I was here all afternoon because I think this is a tremendously important meeting.

I apologize for our being so slow in getting to you. It does not mean that most of us do not think that the groups that you represent have as much input as all the others. We spent a great time listening to the distinguished panel before you, and I thought they had some good ideas.

But as a small businessman myself all of my adult life, I recognize that basically you people represent an area that has not been listened to. So thanks for your patience in waiting while we waded through many things that were very informative to us from the experience of the panel that preceded you because of their involvement in the government over a long period of years.

The main question I ask was touched on, I think, Mr. Albertine, by your last question, and I suspect that--what was the name of the individual from the University of Chicago?

Mr. ALBERTINE. Harberger.

ENTREPRENEURS NEED HELP

Senator EXON. In the last couple of weeks somewhere I read a newspaper article on a book and I think that was the name of the author. I honestly do not remember. He was pointing out that while the Fortune preferred companies are and have been pretty well represented as far as taxation and business policy are concerned; the real entrepreneur, the medium- to middle-sized company who hire most of the people, who have most of the new ideas, who do most of the research and development, the real creators, all too often find themselves with tax policies that are more beneficial to their somewhat larger brothers and not for them. Especially during a time when we are trying to create new jobs, we should go to the entrepreneurs who have proven by their long past and recent past history that they are the ones that need help.

Now, I do not think they want handouts. I just guess that we would have to rely upon you to tell us, the decisionmakers here, what we should do. Maybe there is some part of the tax code that we have overlooked.

There has been a lot of criticism of the tax cuts that have been offered in the last 2 or 3 years, but honestly I suspect because of the recession, they have not been given an opportunity to work.

I know that in all my years of business I watched the profit and loss statement every month and especially at the end of the year, as did my CPA and as did my banker, and the years where we made some money, and if I could take advantage of any of the tax incentives to hire one or two more people or buy a new building or expand our plant and equipment, we did it.

But, boy, in the years we did not make any money, we did not do it because the tax incentives did not do us a bit of good unless we made some money. I suspect it has probably not been said often enough that the last 2 years were not very good tests for how good or how bad the incentives that we really worked into the tax code of all business, and maybe I would say we did not target as well as we should to what I call the entrepreneurs.

That was well stated in this article that I read. I am curious if you think it is the same. It was a book coming out that this man wrote that, as I understood, was not quite out yet, and this was a recap of it.

It was based on the idea that we had not paid enough attention to the entrepreneurs. Does that sound like the same book?

Mr. ALBERTINE. It is the same line of reasoning, Senator, but I think the book is one by Don Gevirtz who is one of the members of the American Business Conference and a very close confidant and friend of Mike McKevitt.

That relates to the issue that Senator Riegle was talking about, that the private sector has a way of figuring out how resources can be allocated efficiently because there is money to be made in doing it. His business, essentially, is making loans to Mike's members to do precisely what Senator Riegle says we need to have done in the system.

REDUCE CORPORATE INCOME TAX

But to answer your question, Senator, last week in Boston the President visited one of the members of the American Business Conference and a group of entrepreneurs in Massachusetts, where someone made a very eloquent presentation on the very point that you are raising, Senator. The President's response to that was that we should abolish the corporate income tax.

Obviously, we are not going to do any reducing of the corporate rate this year or next year or perhaps for the foreseeable future, given the budgetary situation you all face. But I would say the short answer is that mid-size, high growth companies have high effective tax rates.

My own view would be that we ought to have, whenever we can do it, corporate rate reductions and we ought to look at Mike's problem, the very serious one of social security tax increases.

These tax increases are asymmetrically burdensome to small business. There is no question in addition to which those tax increases are employment taxes. Those are the two areas that I certainly would like to see the Congress work on over the next 15 years getting payroll taxes down and cutting corporate rates across the board.

Senator EXON. Now, of course, you talk about getting withholding taxes down. You are going right at the heart of the social security problem. Now, I suspect as businessmen you are not suggesting that we finance the social security shortfall out of the general fund.

Mr. ALBERTINE. No, sir, but I think we would all agree, and Mike is much more knowledgeable and eloquent on this, that there is a very serious problem of trying to take care of the shortfall by raising taxes on employees most of whom are hired by small business and many of whom are disadvantaged young people trying to get into the labor market. It attacks employment, and we have, in that sense, been going in the wrong direction.

TAKE REALISTIC APPRAISAL OF SOCIAL SECURITY SYSTEM

My own view would be that we ought to be looking at taking a realistic appraisal of the social security system. I think Secretary Peterson was absolutely correct in saying that if you look at the fact that the average person is able to get back his entire contribution and his firm's entire contribution in a very short period of time after retirement, then we ought to think about taxing all benefits above that. We ought to think about a permanent restructuring of the cost of living adjustments to make it realistic. We ought to think about the retirement age.

I know that all of that is very difficult a political point of view, but from an economics point of view, the fact of the matter is that these payroll taxes are going to wind up discouraging the employment by small business, particularly of disadvantaged minority youths in urban areas.

Senator EXON. Mike, I would like to have you comment. I am reading you and I feel basically what you are saying is very accurate. The political problem is quite another one. You do not have to worry about that. Mike?

Mr. MCKEVITT. We got into social security taxes, Senator Exon, about 4 years ago because the surveys pointed out coming back from our members that the tax bothering them the most was payroll tax, and we got into the social security tax and started working with Michael Boskin out of Stanford University on this subject.

Then we got into it deeper and deeper and we found out there was a lot of deep problems with it, the divisiveness between the age groups; the intergenerational conflict which I am sure you are already familiar with, which we see more and more; the attitude of employers who say if I hire somebody I am looking at the regulatory burden as I am sure you did of how much time you spend a week just on paperwork and you look at the aspect of the payroll tax where maybe in the past you used to hire summer help or you hired more marginal people than you do now.

Then we began to find we had allies like the American Association of Retired People because a lot of the marginal employees are the elderly. As a result, they came out recently and said they were opposed to more payroll tax increases as well.

I think one of the problems we have to do is get the word across more to people of this country to educate them on what payroll taxes are all about.

I was down there with Albert Lee Gore, for example, and Claude Pepper, I asked the entrepreneurs in the audience to raise their hands. Well, there were about 150 here out of the 1800, and I said now there are your experts. I asked the rest of them, I said you got your experts right here in Nashville, and talk to them about the payroll tax impact, because they can articulate it so well.

I have run three businesses in my lifetime and I think you would agree that you go to bed with your payroll every night and you worry about meeting it because you have the tremendous burden of those people, and you say you are going to look at it when you got more payroll taxes coming at you.

NO LONG-TERM SOLUTION

What troubles me about the forthcoming solution is I do not see a real long-term solution in there, and I think we are going to revisit this problem again in 3 to 5 years if we do not look at it more long term.

We are going to submit our ideas to the Ways and Means Committee next week. We talked to Jim Jones about it, Chairman of the Budget Committee as well. I think there are those obviously who want it wired and want to ram it through.

It may be that the cement is cast and so be it—it is over with, but sooner or later I think we just have to do it, because the problem you do have is for those who are drawing benefits now and really think I paid in fair and square but if they were to find out they really put in about 15 cents for the dollar they get back, what do you do with the people that have other outside income for this growing burden, how do we make it more equitable?

We, of course, have proposed a proposal that you phase in over 9 years and that is make it actuarially sound, but you cannot just throw the baby out with the bath. You have people now who are counting on it, who are deeply concerned about it.

The only age group that is more concerned about social security than those 65 and over is the age group 55 to 65, because they are coming into that realm and saying what is going to be in it for me?

I think a lot of them are going to be hopping mad when they take a look at the tax on the benefit structure and realize that a lot of them are going to get a raw deal, particularly if they are about 55.

So there are problems. Another problem you have that we notice, a lot of our members say, gee, as soon as I can afford it, I want to get into a health program or I want to get into my own retirement program, that their employees are getting nervous and they say when is it coming; I have been with you now 12, 15 years and social security does not look too good. There is a lot of skiddishness about that.

So as a result, our members are very concerned about it, and I guess if I could just say one thing because of the lateness of the hour again, is that one thing I have noticed and I notice particularly, and I think Claude Pepper did down there in Tennessee was people in all age groups were in that audience, and what they said is look, let us do it once and for all, let us solve it. I guess the only thing I regret is I wish the Commission could have just, and I think from the President on down, I think what they do not realize is the American public says, look, enough of the partisan bickering back and forth and finger pointing. Let us really solve this problem once and for all and have a fair, equitable social security program and at the same time be fair to those people who are hiring people out there.

Senator EXON. Thank you. How about the National Association of Manufacturers? Do you find the same concern with payroll taxes as the others?

NAM CONCERNED OVER PAYROLL TAX ISSUE

Mr. HUARD. Yes, we do. As a matter of fact, even if the entire Fortune 1000 were our members, we would still have 9,000 or 10,000 small members with less than 400 or 500 employees, and they are very gravely concerned with the payroll tax issue.

I agree with what Jack and Mike have said, it is a tax on jobs. If you keep raising payroll taxes, you keep depressing jobs. Now, I suspect that the short-term funding solutions recommended by the National Commission on Social Security Reform probably have a good chance of being adopted, and I am certainly not trying to undermine that. I think that may be the most viable result for the short term.

But I really think that long-term solutions for the funding problem for social security have just got to focus on something other than financing it through payroll tax increases because I do not think in the long run that is going to be sustainable.

I think they just have to make the appropriate benefit adjustments. It is not easy. As you know, it is your job and not ours, but I think that is where the solution has to be. I think the payroll tax issue is a very, very serious one.

Senator EXON. Gentlemen, thank you very much. I really appreciate it.

NEGATIVE REACTION TO TRIGGER TAX

Senator KASTEN. I just have one quick question. I understand your position overall on taxes, but specifically, what reaction have you gotten for your membership for the so-called trigger tax that would kick in if we cannot get the Federal budget deficit down? Let's start with you, Paul.

Senator EXON. I think they testified earlier, Mr. Chairman, on that that they did not think much of it. Is not that what you said?

Mr. HUARD. Well, I will briefly repeat it. We are having a board of directors meeting in 2 days. We will probably take a formal position but the preliminary reaction has been pretty skeptical. We feel that it is too far out, that tax decisions ought to be made on a more certain basis and that we have had enough of a yo-yo type problem with capital investment planning, where you have a tax code enacted in 1981 which supposedly provides a certain level of taxation and a certain level of investment incentive, and then in 1982 they change it, and now in 1983, they are coming out and saying, well, maybe we will change it in the future but maybe we will not.

Basically, the reaction has been mostly on the negative side.

Senator KASTEN. John?

Mr. ALBERTINE. Yes, Senator, that is what our members think as well, but let me make one point. I would personally, despite all the problems with the contingency tax, prefer that over Peterson's $60 billion certain tax for fiscal 1985.

At least you can make the argument that the administration has tried to build in the incentive structure in the right direction; that is, the tax only triggers if there are spending reductions.

A $60 billion tax increase that Secretary Peterson was talking about will trigger whether or not there are spending reductions. So I think, as bad as that tax may be, it is better than the $60 billion tax that Secretary Peterson and the others were talking about.

Senator KASTEN. Mike?

Mr. McKEVITT. A former candidate for President, Senator Eugene McCarthy, made a comment to me a couple weeks ago. He said, "If I could give the President one bit of advice, I would tell him to stay away from tax increases and tax cuts. They are very unsettling to the American public."

He put it very mildly. Our members are madder than hell. We have payroll taxes, as I say, kicked up on unemployment compensation as you know, Bob, because you are close to small business with your members there in Wisconsin. You have been a great supporter of small business. They are fed up to here with more taxes. They really are. They are sick and tired of it.

Unemployment taxes, I mean, 1981, 1982, 1983, 1984, 1985, here comes another payroll tax, and they ask me, "What the hell is going on back there in Washington?"

So you talk about a standby tax, no, they are not going to be very excited about it.

Senator KASTEN. On behalf of the committee, let me thank each of you for coming. There may be questions from other members of the committee that will be submitted to you in writing. We hope that you will get back to us with the replies in a timely manner.

Thank you very much.

The hearing is adjourned.

[Whereupon, at 5:35 p.m., the committee adjourned to reconvene on February 3, 1983.]

Outline of Testimony of Peter G. Peterson
Chairman, Lehman Brothers Kuhn Loeb
One of Six Founding Members of Bi-Partisan Budget Appeal
Senate Budget Committee
February 2, 1983

1. Emphasize that Secretaries Dillon, Fowler and myself do not speak for our 500 supporters on specifics of the President's Budget -- on which we have not canvassed them. What they have agreed to support is limited to what appears in the advertisement. Before getting into specifics of his budget, would like to define broad outlines of a growing consensus.

2. Growing consensus -- and worry -- that our economy is not only in short-term trouble but in long-term trouble.
   - 2.1 Short-term troubles do and must get attention. However, too often, we seem to be reacting to this year's Public Enemy #1 -- whether it be high unemployment, high interest rates, high inflation or all of the above.
   - 2.2 However, deepening concern about long-term health of U.S. economy. Is the American Slide of the last decade irreversible? If we allow this slide to continue for another decade or more, will we not only be a weaker and poorer country than we need to be, but a very different country than we have been?

3. Growing consensus that we must get out of this current malaise but at the same time realistically face our long-term predicament.

3.1 Growing recognition that our spending is out of control, born and bred in an era of plenty that no longer is, that we are mindlessly and destructively cheating our future by mortgaging it with huge unfunded and "uncontrollable" liabilities and "contractual" obligations, entitlements and the like.

3.2 Growing recognition that one key is investment in productivity enhancing activities -- plant and equipment, R&D, scientific education, training and retraining, public infrastucture.

  3.21 The comparative Japanese vs. U.S. statistics for investment in the seventies.

3.3 Growing recognition that there are no miracle, instant, painless cures -- supply side or otherwise -- that painful choices will need to be made. Brute questions must be answered. Whose consumption is to be cut? Whose ox is to be gored? You can't invest unless you save, and you can't save and consume at the same time. Thus, we simply must face the longer term spending/consumption side of our economic equation.

3.4 Growing recognition that unprecedentedly high real interest rates are a principal source (and a reflection) of both the short-term economic crisis and long-term economic problem.

3.5 Growing recognition that huge out-year structural deficits are a principal cause of high real interest rates, and a destructive diversion of already limited savings pool from badly needed investment.

4. It is essential that we reconcile the short-term, current economic crisis and the long-term economic predicament.

 4.1 What we believe is needed is a persuasive, unambiguous signal to the financial markets, delivered soon, that the underlying causes of the out-year -- 1985 and beyond -- structural deficits are being attacked -- but the actions themselves, as distinct from the signals, not taking effect so soon so as to jeopardize an already fragile recovery.

 4.2 Why must this signal be sent soon that these structural, building blocks will be in place by 1985? If we don't, the serious risk we take is that any recovery will be tepid and temporary, any recovery will be unbalanced and will ultimately break down from the clashing forces of the private capital needs of a growing economy in recovery with those of a federal government whose structural deficits are at growing and ravenous levels -- leading to destructively high interest rates.

 4.3 On the other hand, if there is such a persuasive signal that the long-term structural deficits will be substantially reduced, that should help bring about a balanced recovery.

  4.31 The current recovery would be broadened --

   4.311 particularly in the interest-sensitive industries (autos, housing, construction, etc.) that are virtually in a depression.

4.312 particularly, by fortifying our weakened -- indeed anemic -- export industries and regain the 1 to 2 million jobs in those industries we have lost due to a seriously overvalued dollar. Those lost jobs, export sales and profits are a serious price we are paying for these very high real interest rates and unprecedented, growing federal borrowing demands.

4.32 The recovery would be deepened by encouraging desperately needed investment.

4.33 We must avoid another exacerbated, unfortunate and unnecessary "Catch 22" collision between tight money and loose fiscal policy or "Catch 22" collusion between long-term loose fiscal policy and long-term loose monetary policy (which would fuel inflationary expectations and long-term interest rates.) We simply must get our fiscal house in order if we are to achieve a healthy balance between fiscal policy and monetary policy.

5. If we are to build a sound, durable, fiscal structure we see a rapidly growing consensus that it will require a fiscal triad.

5.1 Significant cuts in 1985 non-defense areas -- $60 billion --

5.11 Essential that we focus on vast, 100% indexed non-means-tested entitlement programs, subsidies and other programs not targeted on the poor.

- 5.111 Simple arithmetic gets us there (review budget charts)
- 5.112 Simple equity requires us (review pattern of larger reductions in means-tested programs)

5.113 In my own view, as I look at the relatively small additional dollar reductions in some of the means tested programs that have been proposed in the President's budget -- $1 billion each in food stamps and AFDC, $450 million in energy and emergency assistance, $850 million in medicaid -- I am driven to the conclusion that in relation to a $250 billion deficit (as I look at the need to build a bi-partisan consensus that the burden sharing is fair) much can be said for showing unusual diligence and sensitivity in reviewing each of the additional proposed reductions in programs targeted to the poor. I believe that we in the middle and upper income groups and organizations need to demonstrate that we are stepping up to the plate.

Programs to the poor are clearly not the enemy of fiscal prudence. Rather, the poor are the principal victims of this economic malaise. As Pogo would have said, the principal fiscal enemy is us, those of us in the middle and upper income groups and organizations who are the principal beneficiaries of the most rapidly growing -- and up to now largely untouched -- programs.

There is much talk about the safety net for the needy. In fact, it is the well padded hammock for the middle and upper income groups that must now be the focus of the spending reduction efforts.

5.2 Meaningful reductions in defense budget -- $25 billion in 1985 budget plus whatever one gets in military pensions --

- 5.21 Consensus behind sustained and sustainable defense build-up -- such a reduction still permits that.
- 5.22 Must be perceived to be, as well as be, sustainable to our allies and adversaries alike, economically and politically.
- 5.23 Strong foreign policy and defense requires a strong economy.
- 5.24 Given political vectors in American politics, very unlikely to get indispensable reductions in non-means-tested entitlement programs unless defense shares meaningfully in deficit reduction effort.

5.3 Significant tax increases will be necessary -- not now which would be counterproductive -- but enacted soon to be in place by 1985 -- in the context of a growing economy. (A key part of an unambiguous signal to financial markets.)

5.31 What is clear to financial markets -- and the country now -- is that once again, it has been far easier to cut taxes than to cut spending.

5.32 If we agree that national priorities require that we spend a certain level of resources, then we must pay for it directly and honestly, and not "borrow" it. We are a rich country. We can afford to pay for government we need.

5.33 The case for consumption-based taxes. Ours is the most pro-borrowing, pro-consumption and anti-savings and anti-investment tax system in the industrial world.

6. Overall appraisal of President's Budget.

6.1 Some Positive Factors

6.11 Praise the new fiscal realism in this Budget. Bi-partisan budget appeal group deeply concerned about lack of it previously.

6.12 Praise focus on certain non-means-tested entitlement programs -- i.e., freeze in federal and military pensions.

However, as our advertisement points out, fiscal reform also requires cap on indexing process that drives the non-means tested programs.

6.13 Praise focus on medicare and the perverse and negative incentives that are driving up the costs of these programs.

6.14 Praise new emphasis on science eduction research and development.

6.15 Praise commitment to expanding trade.

6.2 Some concerns about 1985 budget vs. bi--partisan appeals

6.21 Deficits still too big for too long (see charts for comparison to bi-partisan goal).

6.22 Defense budget reductions inadequate.

6.23 Reductions in non-means tested program not substantial enough.

6.24 Contingent tax increase in 1986. Clear to us the deficit is enormous even with sustained growth -- about $200 billion in 1985 -- even with 5% real growth. Thus, we should face unpleasant fact that 1985 tax increases are needed. All this in context of our spending reductions being made.

January 18, 1983

DEAR MR. PRESIDENT: (DEAR MR. SPEAKER:) (DEAR SENATOR BAKER:)

BI-PARTISAN APPEAL ON THE BUDGET CRISIS

We are renewing an appeal made originally last May for a bi-partisan solution to the serious fiscal and budgetary situation facing the nation over the remainder of this decade and beyond. Your leadership is critical to any such solution. We want you to know that in exerting that leadership you will have our full, active and public support.

Since the original appeal we have been joined by about 500 eminent Americans, from both political parties. Their names appear on the enclosed statement which will be published shortly. We hope you will be as encouraged as we are that the men and women who guide many of America's major institutions of commerce, finance, law and learning are now ready to step forward on this issue and lend their united assistance to the nation's political leadership.

This appeal is made in an entirely constructive spirit. We are not pointing fingers or assigning blame. Today's fiscal and budgetary crisis has deep roots in every administration and Congress which has served over the last 20 years or more, including those of which we were a part. Both as former public officials and leaders of the private sector, we must ourselves accept a measure of responsibility for the immense structural deficits which have become embedded in the federal budget.

Also we recognize that there has been some progress since our original appeal. Some important measures have been enacted with your support to slow down spending and to increase revenues. Further, there is now bi-partisan agreement that the fiscal crisis is real and of massive dimensions. We applaud your efforts in advancing public understanding of the budgetary situation.

Nevertheless, the budgetary outlook remains dire. Even assuming sustained economic recovery the federal budget is primed to generate annual deficits in the range of 250 billion dollars in the mid-1980's with the budget gap widening with each passing year. Such deficits would drain the nation's shallow pool of savings into a virtual desert.

At least in peacetime, the private sector of the American economy, in which the large part of production, jobs and healthy economic growth must be generated, has never before faced such extreme conditions of capital shortage. On this course, we could not expect either sustained economic growth or genuine price stability, and we would certainly face a decade or more of dangerously inadequate investment in productive plant, equipment, R&D and public infrastructure. This we fear is a prescription for economic stagnation with no end in sight.

Furthermore, the prospect of giant deficits in the future is posing a current obstacle to the hoped for economic recovery. Because every lender and borrower must anticipate excessive federal claims on the nation's capital resources for years to come, medium and long term interest rates remain abnormally high, especially relative to current inflation rates. These high real interest rates are in turn leading to an abnormally strong dollar on the foreign exchange market, putting America's export industries at a severe disadvantage and endangering the millions of jobs which depend upon them. Until the government transforms its long term budget outlook, the economy will likely remain locked into a depressed and unstable condition.

Our principle concern is not today's deficit which is obviously in part a result of today's recession. The huge deficits in prospect for the mid and late 1980's are different. They are largely the result of embedded federal policies, not abnormal economic conditions and they are a primary cause of today's continuing economic distress.

The point is to take legislative action now so that the out year deficits, 1985 and beyond, will be considerably smaller than those now projected. This signal to the capital markets is essential for economic recovery.

In our judgment, the fiscal 1985 deficit -- projected on conservative and realistic economic assumptions -- should be cut from the roughly 6% of GNP now projected to at the very least 2% of GNP, the average deficit to GNP relationship which has prevailed over the last decade or so. The ultimate goal must be to move the budget into balance as the economy moves to a normal level of activity.

In political terms this 1985 goal is nonetheless ambitious. We compute that it entails reducing the projected 1985 deficit by about $175 billion. As a matter of sheer arithmetic there is no way to do this without making major changes in each large sector of the budget -- social spending, defenses, taxes. There is accordingly no room in the exercise for sacred cows, whether ideological or partisan. The task requires that everyone involved makes compromises from previous commitments and positions. Just as the fiscal crisis has had bi-partisan authorship, so its solution must be genuinely bi-partisan.

We have not presumed to lay out a line by line program of budget reform. That can be done only by you and your colleagues. But the basic contours of the solution are, we think, dictated by certain stark realities we face as a nation.

In the area of social spending, big changes must come in those entitlement programs -- chiefly Social Security, military and civil service pensions and the like -- which confer most of their benefits on middle and upper income groups. There are two reasons. First, that is where the massive bulk of social federal spending takes place. The means-tested programs which target the poor --for example AFDC, Medicaid, food stamps and the like -- are far smaller and, as a result of budget actions already taken, are growing far more slowly. Second, no program of fiscal reform can take place unless the country is convinced of its basic fairness.

Spending on these big entitlement programs can be held down only if we directly reform the automatic inflation indexing system which has driven these programs through the roof. We recommend a freeze of one year on all such indexing and a firm reduction in the rate of indexing in future years. (Such temporary steps are not a substitute for the required long-term, structural reforms of these programs.) Such a regime, as well as reductions in otherprograms and subsidies, can and should be designed to avoid hardship for beneficiaries who are poor and therefore critically dependent on their benefits.

In the area of defense, the indispensable goal is to revive a bi-partisan consensus behind a sustained buildup in our military security. This important national consensus is now threatened by a sense that defense spending may be rising faster than our security planners have been able to rationalize. By sensibly moderating the pace of that buildup, we will not endanger its military effectiveness. Rather, we will reestablish the political and economic conditions necessary to sustain a substantial buildup over the long haul. Our adversaries and allies alike will be far more impressed by a sustainable effort than by a brief spurt followed by yet another period of complacency and neglect. The signal we should be sending now to the world is that the Congress is united behind the President in a program to rebuild our military strength. A message of disharmony would detract dangerously from the credibility of our entire defense effort and, indeed, of the President, as Commander-in-Chief.

Finally, in the area of taxes, it is vital to keep in mind that a central purpose of budget reform is to stop the federal drain on the nation's pool of savings and to revive productive investment in the private sector. This means that the first priority is to cut spending -- the main force moving resources from private investment into publicly subsidized consumption. Likewise to raise taxes directly on savings and investment activity would make the budget reform exercise self-defeating. More revenue is, however, needed. It should come principally from increased taxation on consumption activities.

A program of fiscal restructuring which meets, in general shape and size, these broad principles would have our support.

We wish at any rate to reemphasize our commitment to build bi-partisan support throughout the country for those tough decisions which you and your colleagues must now make if the nation's fiscal integrity is to be restored. You carry an awesome burden. We believe you have the right to expect the help of every responsible American, regardless of party.

Thank you for considering our views.

Respectfully,

W. Michael Blumenthal

Henry H. Fowler

John B. Connally

Peter G. Peterson

C. Douglas Dillon

William E. Simon

To the President and the Congress

A BI-PARTISAN APPEAL TO RESOLVE THE BUDGET CRISIS

The federal budget is now out of control. It is primed to generate immense deficits, year after year, for decades ahead--deficits far larger than any in our history. This fiscal course is senseless. It threatens to lock the economy in stagnation for the remainder of this century. Massive deficits would absorb savings urgently needed for investment in plant and equipment, infrastructure and R&D. Productivity would sag and inflation resurface. Interest-sensitive industries would be smothered and exports would dwindle. The result would be a period of gradual decline, punctuated by high unemployment and social conflict and culminating in an America that is permanently poorer and weaker.

The Nation cannot afford to leave the budget to politics as usual. It is time to set aside differences of party, region and ideology. We appeal to you, our leaders, to display true leadership in the spirit of national unity, to resolve the current crisis. Only if you do so can the balance of this century yet be a time of prosperity and growth, of new jobs and higher standards of living. And only if it is, can we leave future generations with a richer and stronger America.

THE BUDGET DISASTER

Despite the budget actions of 1981 and 1982, the deficit has just topped 100 billion dollars for the first time in history and will rise beyond 200 billion dollars--5% to 6% or more of GNP--by the mid-1980s. After 1985, the deficit outlook actually worsens.

We are rapidly moving into uncharted fiscal territory. Deficits now in prospect have no precedent in our peacetime history, either in periods of sturdy growth or recession.

Furthermore, it is now widely realized that the solvency of the Social Security system is clearly threatened. It is now acknowledged that from 1983 to 1990, the Social Security system alone will run cumulative deficits approaching 200 billion dollars. By the year 2000, the system's annual deficit, including Medicare, could reach over 350 billion dollars, in spite of significant increases in Social Security taxes between now and 1990.

THE SOURCES OF DISASTER

Today's deficit is partly caused by the recession, reflecting a shortfall in tax revenue caused by today's weak economy. The present recession has clearly been aggravated by a collision between tight money and loose budget. Recovery requires a better balance between the two policies. Making the budgets even looser will make such a balance and thus a healthy recovery virtually impossible.

The crux of the budget problem resides not in 1983 but in the ensuing years. The startling growth in the deficits projected for the mid-1980s and beyond is not recession-related. These immense, structural deficits will take place even on the happy assumption that economic recovery commences immediately and proceeds at a sustained, healthy pace. We cannot "grow out of" this deficit shadow. Even if real GNP grows at a buoyant annual rate of 5% over the next 3 years, the 1985 deficit still will be about 200 billion dollars. On the other hand, if economic recovery is partial or halting (a more likely case, because massive federal borrowing will itself retard the recovery) the 1985 deficit could reach 250 to 300 billion dollars.

The growth in tomorrow's deficits arises not from today's economic recession but from yesterday's government policies. Recent tax legislation will keep relatively constant the share of national income going to federal taxes over the next several years. But federal spending, already authorized or announced, will be rising as a share of national income.

Federal spending no longer fluctuates in parallel with national needs. It no longer rises and falls much due to emergency defense programs to meet temporary crises, or due to cyclical outlays designed to counter recessions, such as unemployment compensation or jobs programs. Rather, 75% of the budget now flows into open-ended social entitlement programs, contractual interest expenses, and long-term defense modernization, and by 1985 this proportion would grow to over 80%. These long-term commitments have enormous momentum. They are scheduled to grow rapidly--in absolute terms, as a share of the budget, and as a share of GNP--for as far as we can project. That is why, as now structured, the federal budget would never achieve balance, but would sink deeper into the red with each passing year.

Thus, we face a basic mismatch of tax and spending policies:

- Recent tax cuts will keep total federal revenues fixed at 18% to 20% of GNP over the 1980s.
- By contrast, the growth in total spending has not been reduced. Quite the contrary. Without further budget cutting, spending in 1985 is projected to equal 25% or more of GNP, up from 22.4% in 1980--an increase of about 380 billion dollars.
- This spending growth comes from three sources: social *entitlement programs* unrelated to means tests, such as Social Security, Medicare, and federal pensions; the *defense* buildup; and *interest* on the debt.
- Under current laws, these non-means-tested social "entitlement" programs would grow by over 150 billion dollars--from 227 billion dollars in 1980 to 380 billion dollars in 1985--rising from 8.8% to about 9.9% of GNP. (By contrast, social programs targeted to the poor will decline relative to the economy, from 2.2% to about 2% of GNP. Budget actions to date have reduced the growth in these means-tested programs by more than twice as much on a percentage basis as non-means-tested programs.)
- Defense spending, under the currently planned buildup, will increase by 150 billion dollars, a real (after inflation) increase of about 9% a year--over 15% per year in hardware items--lifting defense (not including military retirement) from 4.8% in 1980 to about 7.1% of GNP in 1985. (By contrast, public investment, grants to state and local governments, and federal operating expenses will actually decline from about 4.6% to about 2.9% of GNP.)

THE CONSEQUENCES

Huge deficits--and high real interest rates, with few precedents in modern history--risk denying too many Americans any chance at sustained jobs and prosperity in the new decade, after a decade in which real median income per worker showed little or no increase and unemployment rose to higher levels.

- *Recovery from today's recession could be feeble and temporary as a result. Depression conditions now prevail in most industries which sell their product on long-term credit: housing, automobile, construction, durable goods and the like.*
- *High long-term real interest rates, largely attributable to concern over future government policy, would remain abnormally high, holding back new investment, which in recent years has been the lowest of any industrial country and is now declining still further. High short-term real interest rates would threaten to push thousands of small businesses and farms into bankruptcy--to say nothing of the adverse effects on the fragile economies of the developing world as well as on the global financial system.*
- *Dollar exchange rates--now at lofty levels that have already crippled our export industries, overwhelmed our manufacturers in practically every international market, and have cost us an estimated one to two million job opportunities in the current period--would remain artificially high; they would continue to choke off American exports, suck in imports, destroy U.S. jobs, and could make the temptation of full scale protectionism irresistible.*
- *As a result, capital formation and job creation would continue to stagnate, making unacceptably high unemployment a fixed feature of the industrial landscape.*

Thus, tomorrow's big deficits, and the high long-term real interest rates that will accompany them, are already doing serious damage now and will wreak even more havoc in the coming decade and beyond. *Without savings available to fuel productive investments, the economy will face nearly perpetual stagnation.*

In short, by losing control of the budget, we are sacrificing the jobs and prosperity of our children and grandchildren, and shrinking America's stature and influence in the world.

PRINCIPLES FOR BUDGET REFORM

Budget crisis transcends conventional politics. *No solution is possible through partisan maneuver.* We, the undersigned, believe Americans must now rally around three basic principles of budget reform:

1. **Focus on the Long-Term.** Financial markets, and the American people, are worried by today's deficits, but much more by the huge deficits now in prospect for the mid-1980s and beyond. Today's *government actions must commit to a substantial, progressive scaling down of those outyear deficits.* The reforms must be large, structural, and permanent--equal to the size and duration of the problem itself. Temporary, one-shot actions won't do any good.

2. **Fairness.** Balancing the budget on the back of just one group or one set of programs is not feasible, and trying to do so would not be fair. So far in 1981 and 1982, the budget cuts have focused on the *means-tested programs*, through reductions in Medicaid, AFDC, food stamps, legal services and the like. The much larger programs which have been barely touched are those social programs that confer a large part of their benefits on middle and upper income groups (such as Social Security and federal pensions) and the military defense programs. Together, such programs in 1985 would amount to over 650 billion dollars in spending or 68% of the budget (interest on the national debt would be another 12%). *It is now time for a wider sharing of the burden.*

3. **Focus on Investment.** The chief vice of uncontrolled spending and big deficits is that they *rob the future*, by absorbing investment capital needed to build up productive jobs and real income for tomorrow. (Beginning in 1983, budget deficits will amount to a stunning and unprecedented 100% of the net savings generated by individuals and families in the U.S.) The 1980s should be a decade of investment, not a decade of red ink. Cutting deficits by measures that would simultaneously reduce savings and productive investment would make no sense. Budget reform should protect the future. As we squeeze the share of GNP taken up by federal spending--which we must--*we should concentrate on programs that subsidize consumption* (e.g., the social entitlement programs) and spare programs of public investment (e.g., R&D and economically sound public works). When increasing revenues, we must focus our new taxes on private consumption and not on private savings and investment.

THE GOAL

We must put the budget on a multi-year path toward balance.

To achieve credibility in long-term financial markets, a program of fiscal reform must aim, at a minimum, *to cut the projected 1985 deficit by about 175 billion dollars.* This would bring the 1985 deficit to the 75 billion dollar range. Also, specific actions taken in 1983 should assure budget balance within a few years thereafter. If we do less than this, future deficits will likely remain well above 2% of GNP for years to come, which would make the nation's financial and investment situation in the 1980s even worse than in the 1970s. The last decade was bad enough for the nation's economic performance. To invite a further drop in our economic performance would be totally irresponsible.

We recognize that this budget reform is not the only action necessary to achieve long-term economic recovery. Many who signed this statement also favor other changes, such as in monetary policy, in the structure of the Social Security and federal pension systems to assure their long-term affordability and financial integrity, in support for research and development, in tax incentives for savings and capital investment, in manpower retraining, in rebuilding public infrastructure, in reformed exchange rate systems, in export policies, etc. But we are firmly united in our conviction that such measures will not prove effective without basic and major changes in budget policies.

A PROGRAM FOR IMMEDIATE ACTION

We can remake the budget without gutting our military security, without starving private savings and investment, and without putting harsh burdens on the poor. But we will have to address head-on each of the three major sources of runaway deficit: the growth of large social entitlement programs, the growth of defense spending, and the inadequacy of tax revenues. If any of these areas is placed "out-of-bounds", no fair or effective solution to the problem is possible.

We, the undersigned, rarely stand together on political and economic issues. But we believe Americans must rally to the common cause of fiscal responsibility. We support this plan as a fair, realistic, and bi-partisan approach toward regaining mastery over our economic destiny, and we commend it to you for early action.

1. **Entitlements and Other Non-Defense Programs.** *We should now slow down the growth in non-defense spending so as to reduce the deficit by about 60 billion dollars in 1985.* The best way to begin is with a one-year freeze in the growth of benefit levels of cash payments flowing from the large, non-means-tested entitlement programs: Social Security, veteran's benefits, civil service and military retirements, and other non-defense subsidies and payments that are not means-tested. Thereafter, there should be limits on the automatic inflation indexing of benefits (e.g., by capping inflation adjustments at 60% of the CPI, or at 4% per year, or by providing adjustments only for the amount of inflation in excess of 3% per year). *However difficult politically, controlling the budget requires controls on the large entitlement programs and on the inflation indexing process that drives the cost of these programs upward. If these programs are instead placed off-limits, it will be impossible to make budget savings now necessary for financial stability.* Similar restraint is required on all transfers, subsidies, and programs other than those essential to the needy.

   These measures can be carried out in ways to protect those citizens truly in need.

2. **Defense.** *The defense budget increases now planned should be moderated so as to save about 25 billion dollars in FY 1985.* This would still provide for a major and sustained defense buildup, an overall increase in real terms between 1981 and 1985 of about 7% and an increase in hardware purchases of about 11% per annum. It would encourage more explicit planning for that buildup and lead to wider, sustained public support for a strong defense posture.

3. **Taxes.** Revenues should be increased by about 60 billion dollars in FY 1985. The principal source of these increases in revenue should be from *consumption-based taxes*, and by imposing user fees for the government's commercially valuable services. Modifying, delaying, or stretching out the income tax cut for 1983 has the unanimous approval of the undersigned members *only* in the context of a prior agreement on the kind and magnitude of spending cuts referred to in parts 1 and 2 of this program.

These steps, if undertaken now, would cut the FY 1985 deficit by about 145 billion dollars. This in turn could lead, through less federal borrowing, to a further deficit reduction of about 30 billion dollars in lower interest payments. We would then meet the overall target of about 175 billion dollars in FY 1985 deficit reductions.

LEADERSHIP

The program we suggest would require tangible sacrifices from many middle and upper income citizens. But the sacrifices would not be severe, and they are simply necessary to avoid economic chaos and stagnation. Inaction would exact enormous and unnecessary sacrifices from every American.

The budget crisis is a national crisis. Only a united leadership in Washington, extending across both parties and embracing liberals and conservatives alike, can avert a fiscal disaster. Let us work together, as Americans, to rescue the future of our economy . . . and our country.

Paid for by: **The Bi-Partisan Budget Appeal,**
55 Water Street, 43rd floor, New York, New York 10041

FOUNDING MEMBERS

The Hon.	The Hon.	The Hon.	The Hon.	The Hon.	The Hon.
W. Michael Blumenthal	**John B. Connally**	**C. Douglas Dillon**	**Henry H. Fowler**	**Peter G. Peterson**	**William E. Simon**
Secretary of the Treasury	Secretary of the Treasury	Secretary of the Treasury	Secretary of the Treasury	Secretary of Commerce	Secretary of the Treasury
1977-1979	1971-1972	1961-1965	1965-1968	1972-1973	1974-1976

Supporters of the Bi-Partisan Appeal on the Budget Crisis*

Former Public Officials

[illegible]

Educators, Economists, Foundations

[illegible]

Organizations

[illegible]

Law Firms-Chairmen, Managing & Senior Partners

[illegible]

Accounting Firms-Chairmen, Managing & Senior Partners

[illegible]

Investment Banking-Chairmen, Managing & Senior Partners

[illegible]

Corporate Executives

[illegible]

Communications, Advertising Agency Executives

[illegible]

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*[illegible]

A Bipartisan Appeal To Resolve The Budget Crisis

Presentation
Senate Budget Committee
February 2, 1983

FOUNDING MEMBERS

The Hon.	The Hon.	The Hon.	The Hon.	The Hon.	The Hon.
W. Michael Blumenthal	**John B. Connally**	**C. Douglas Dillon**	**Henry H. Fowler**	**Peter G. Peterson**	**William E. Simon**
Secretary of the Treasury	Secretary of the Treasury	Secretary of the Treasury	Secretary of the Treasury	Secretary of Commerce	Secretary of the Treasury
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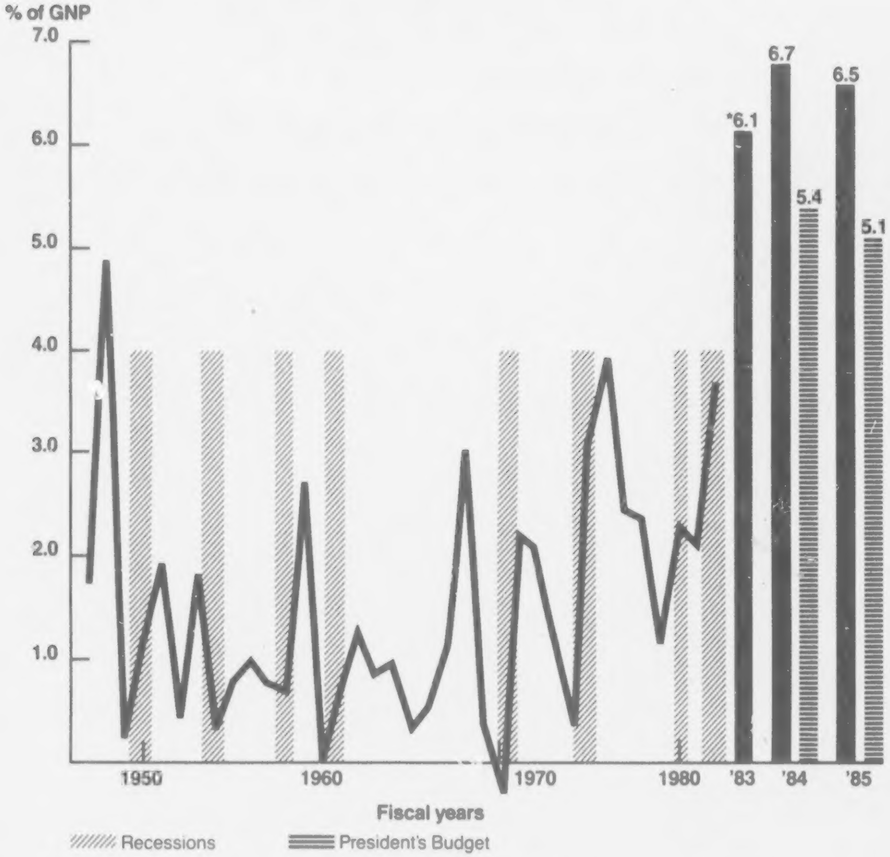
The Problem

- Unprecedented, unending, growing deficits
- Growing mismatch between revenues and spending
- Will drain already limited savings
- Will rob critically needed investment in the future
- Near depression conditions now in interest sensitive industries

Uncharted Fiscal Territory

BUDGET DEFICIT AS PERCENT
GNP (1949–1985)

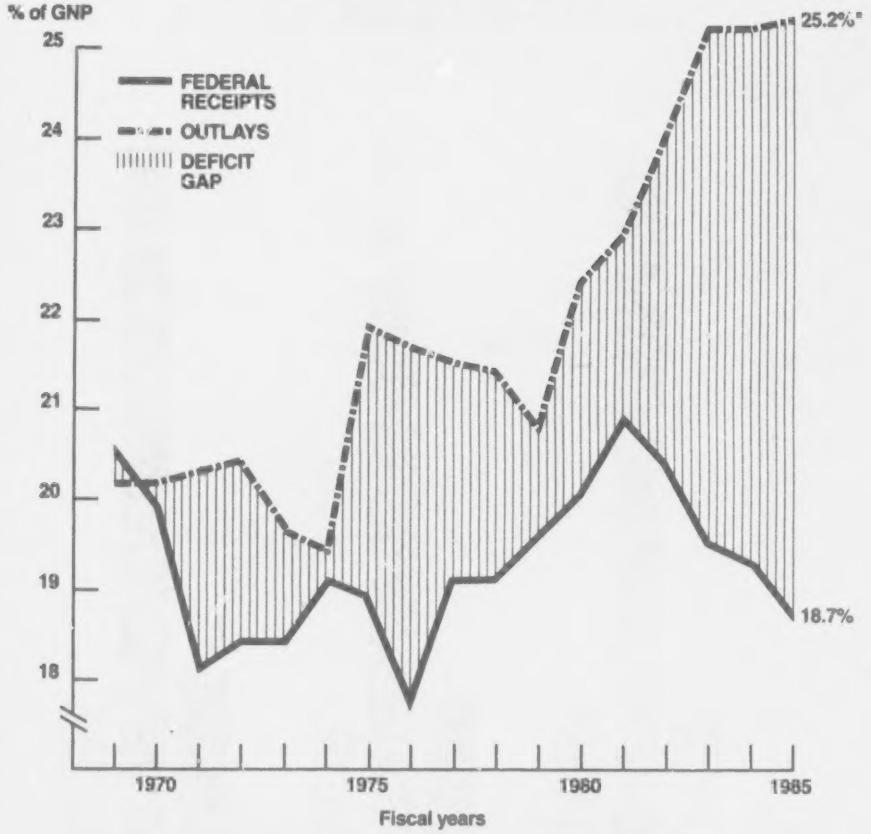


*Estimated, assuming no new reductions and 3-4% real GNP growth per year (1983-1985).

Source: Federal Reserve Bank of New York
Congressional Budget Office
Office of Management and Budget

3.

Growing Gap in Share of GNP: Receipts VS Outlays

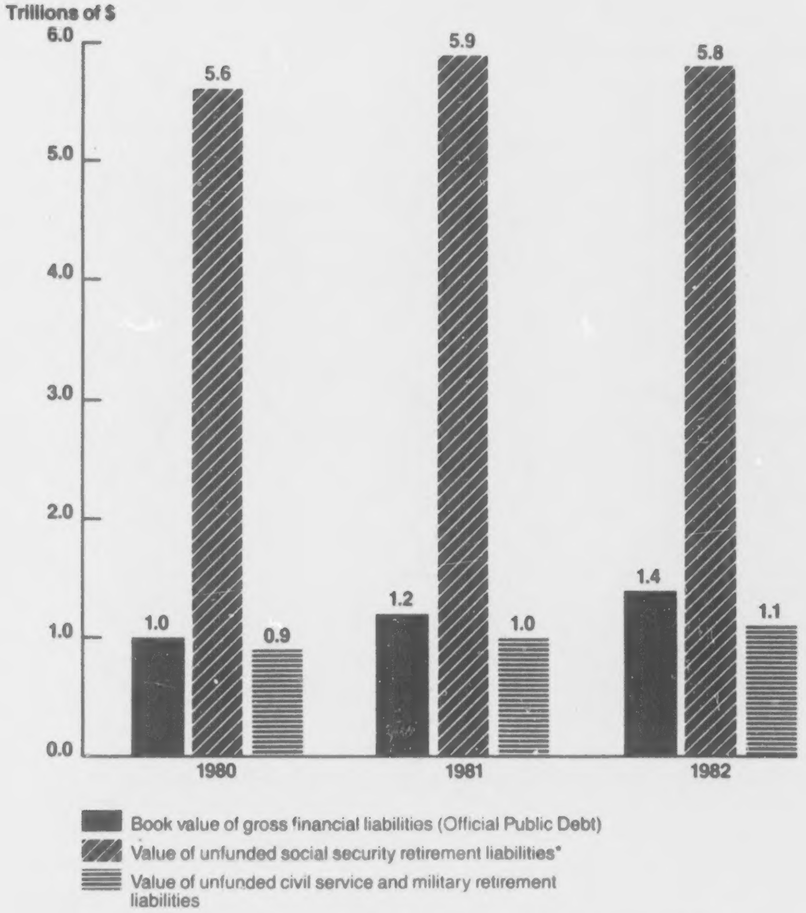


*1983–1985, estimates assuming no new reductions and 3-4% real GNP growth per year.

Source: Federal Reserve Bank of New York
Congressional Budget Office
Office of Management and Budget

Why the Federal Deficit Problem Will Not Go Away

COMPONENTS OF THE FEDERAL DEBT (BY FISCAL YEAR, TRILLIONS OF DOLLARS)



*unfunded liabilities is the amount by which expected benefits to current participants exceed their scheduled future taxes or contributions.

Source: Office of Management and Budget

Deficits Must Not Be Allowed To Soak Up Savings: Would Cut Amount Available For Net New Private Investment To *Half* Of Previous Levels

(SAVINGS AS A PERCENT OF GNP)

	1961 to 1970	1971 to 1980	1985		
			$250 billion deficit	$75 billion deficit	$195 billion deficit*
Gross Private Savings	16.4	16.9	18.0	17.4	17.8
Personal	4.7	4.9	4.8	4.4	4.7
Business	11.7	12.0	13.2	13.0	13.1
Total Use of Savings	16.4	16.9	18.0	17.4	17.8
Less: financing the federal deficit	0.5	1.9	6.5	2.0	5.1
other **	0.5	−0.9	−1.5	−1.0	−1.3
Equal: amount available for gross private investments	15.4	15.9	13.0	16.4	14.0
Addendum: capital consumption allowance	8.4	9.9	9.8	9.8	9.8
Amount available for net new private investments	7.0	6.0	3.2	6.6	4.2

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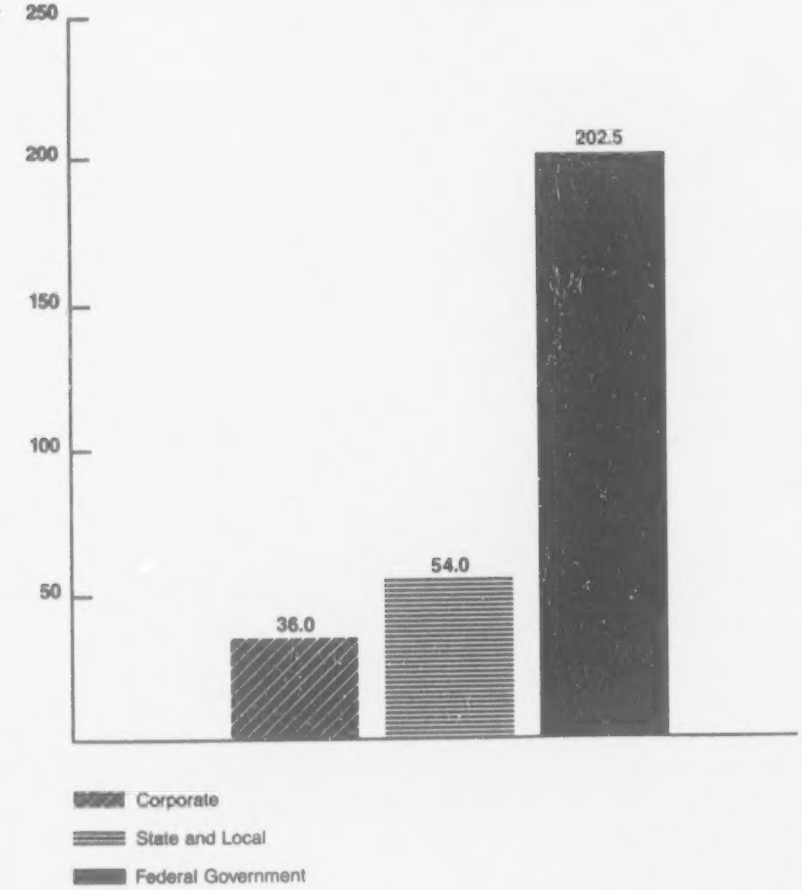
* President's Budget

** Includes net foreign investment, state/local deficits.

Net New Borrowing in 1982
(billions of dollars)

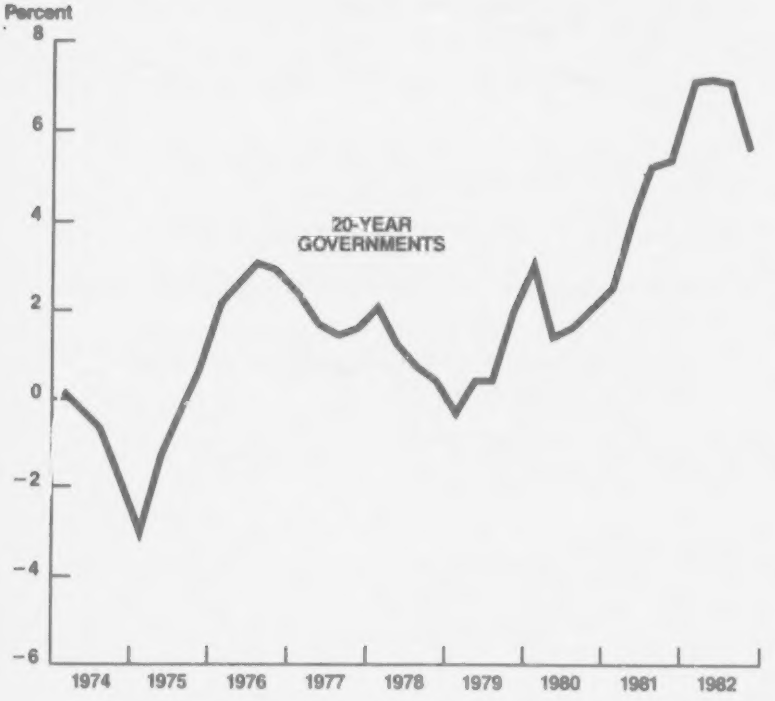


7.

Source: Federal Reserve Bank of New York

Unprecedented Levels Of Real Interest Rates*

*INTEREST RATES ADJUSTED FOR CURRENT INFLATION RATES



*Nominal rate minus four-quarter change in GNP deflator.

Adverse Impact Of Unprecedented Real Interest Rates

- Short Term—Near depression in interest sensitive industries (Autos, Housing, Construction, Durable Goods) This also depresses demand in basic industries and capital equipment.
- Discourages investment, capital formation and job creation.
- Overvalued dollar—enormous negative effects on jobs and exports—protectionism.
- Bankruptcies—continuing fragile balance sheets.
- Developing Countries—world economy—global financial system.
- Results in unacceptably high unemployment—fixed feature of industrial landscape.

Principles of Budget Reform

- Long term emphasis (1985 and beyond)
- Focus on spending—particularly programs that subsidize consumption
- Promote investment
- Fairness

GOAL

How Much Does the Deficit Need To Be Cut? —About $175B in 1985

Thereby Achieving Overall Goal of Deficit Less Than 2% of GNP, Heading Toward Balance

1985 Nominal GNP ≈ $3,800B to $4,000B
2% ≈ $75B

1985 Deficit Projection $250B
target 75B
required reduction $175B

Where In The Budget Have There Been Actual Cuts In Dollars?

		1985 Projection		1980–1985 Change	
	1980 Actual	Baseline	President's Budget	Baseline	President's Budget
National Defense	$123.9B	$273.5B	$267.9B	+$149.6B	+$144.0B
Benefit Payments*					
Means tested	55.9	80.3	76.4	+24.4	+20.5
Not means tested	227.1	380.1	366.5	+153.0	+139.4
Grants to State/Local Governments	57.2	53.6	50.7	$\boxed{-3.6}$	$\boxed{-6.5}$
Other Operations and Subsidies	60.1	59.0	42.9	$\boxed{-1.1}$	$\boxed{-17.2}$
Net Interest	52.5	121.9	114.2	+69.4	+61.7
Total	+576.7B	$968.4B	$918.5B	+$391.7B	+$341.8B

*Mostly Entitlements

12

Source: Federal Reserve Bank of New York
Congressional Budget Office
Office of Management and Budget

Where In the Budget Has the GNP Share Declined?

		1985 Projection		1980–1985 Change	
	1980 Actual	Baseline	President's Budget	Baseline	President's Budget
National Defense	4.8%	7.1%	7.0%	+2.3%	+2.2%
Benefit Payments**					
Means tested	2.2	2.1	2.0	−0.1*	−0.2*
Not means tested	8.8	9.9	9.6	+1.1	+0.8
Grants to State/Local Governments	2.3	1.4	1.3	−0.9	−1.0
Other Operations and Subsidies	2.3	1.5	1.1	−0.8	−1.2
Net Interest	2.0	3.2	3.0	+1.2	+1.0
Total	22.4%	25.2%	24.1%	+2.8%	+1.7%

*In 1981, 1982, projected levels scaled back over twice as much as non-means tested (10.1% vs 4.7%); in the President's new budget means tested scaled back by 4.9% versus 3.6% for non-means tested

**Mostly Entitlements

13.

Source: Federal Reserve Bank of New York
Office of Management and Budget

Federal Spending

NOWHERE TO GO FOR LARGE CUTS BUT ENTITLEMENTS AND DEFENSE

	1985 projection	
	$billions	% of budget
National Defense	$273.5B	(28.2%)
Benefit Payments*		
Means tested	80.3	(8.3%)
Not means tested	380.1	(39.2%)
Grants to State/Local Governments	53.6	(5.5%)
Other Operations and Subsidies	59.0	(6.1%)
Net Interest	121.9	(12.6%)
Total	$968.4B	(100.0%)

80% Of Budget

$175B Goal amounts to 17% to 18% of Budget

*Mostly Entitlements

Source: Federal Reserve Bank of New York
Office of Management and Budget

Budget Reform: Indispensible But Not The Only Action

Other possible changes:

- Monetary policy
- Social Security and federal pensions
- Research and development
- Tax incentives for saving and capital investment
- Rebuilding public infrastructure
- Education and retraining
- Reform exchange rate system
- Export policies
- Other

However, any such measures will not prove effective without basic changes in budget policies

The Bipartisan Program

	1985 Deficit Reduction Target	1985 President's Budget
1. Entitlements and other non-defense programs	$ 60B	$ 36B
2. Defense	25	6
3. Taxes	60	10
These 3 areas of deficit reduction would lower the Federal interest costs* by	30	6
Total 1985 Reduction:	**$175B**	**$58B**

*for 1983-1985, interest rate assumptions are those specified in the First Concurrent Resolution for 1982, declining to a rate of 7.4% in 1985.

1985 Deficit
Reduction
Target
$60B

1. Entitlements and Other Non-Defense Programs

- 1 year freeze on cost of living adjustments for major entitlement programs
  (Social Security, Veterans Benefits, Civil Service and Military Retirement, etc.)
- Cap on indexing thereafter
  (eg: 60% of CPI, only in excess of 3%, etc.)
- Similar restraint—transfers, subsidies and other programs not essential to needy
- Carried out in ways to protect the citizens truly in need

Savings to the Federal Budget
From the Commission's Reforms[1/]
(fiscal year, billions of dollars)

Reform	1983	1984	1985	1986	1987	1988	1989	1983-1989
Tax Retirement Benefits	$0.0	1.1	3.9	4.6	5.3	6.2	7.2	28.3
Move Up Tax Increases	0.0	5.2	-2.6	0.0	0.0	8.7	12.1	23.4
Increase Self-Employed Tax	0.0	0.6	1.6	1.5	1.6	1.9	2.3	9.5
Military Credit From Treasury	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
COLA Delays	2.0	4.3	4.1	4.0	4.0	4.0	4.0	26.4
Expand Coverage	0.0	0.2	0.6	1.0	1.3	1.3	1.6	6.0
Ban Early Withdrawal	0.0	0.0	0.0	0.0	0.8	1.0	0.8	2.6
Adjust Benefits For Spouses and Disabled Widows and Widowers	*	*	*	*	*	*	*	-1.3
Total[2/]	2.0	11.4	7.6	11.1	13.0	23.1	28.0	94.9

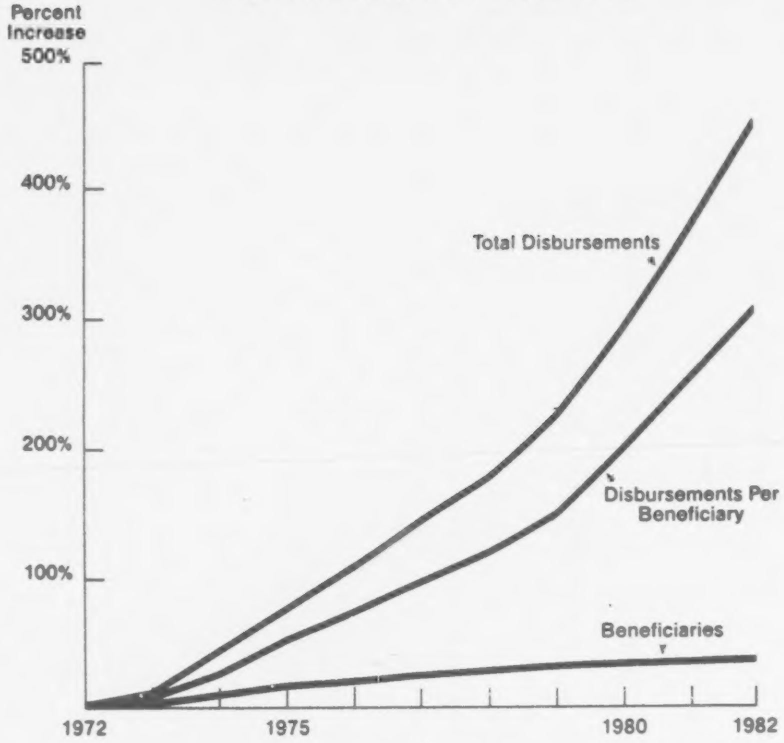
[1/] Totals may not add due to rounding.

[2/] Annual savings totals do not include the $1.3 billion dissaving from adjusting benefits for spouses and disabled widows and widowers.

17A

What Is Primarily Responsible For Medicare's Explosive Growth: The Increase In Beneficiaries Or The Increase In Disbursements Per Beneficiary?

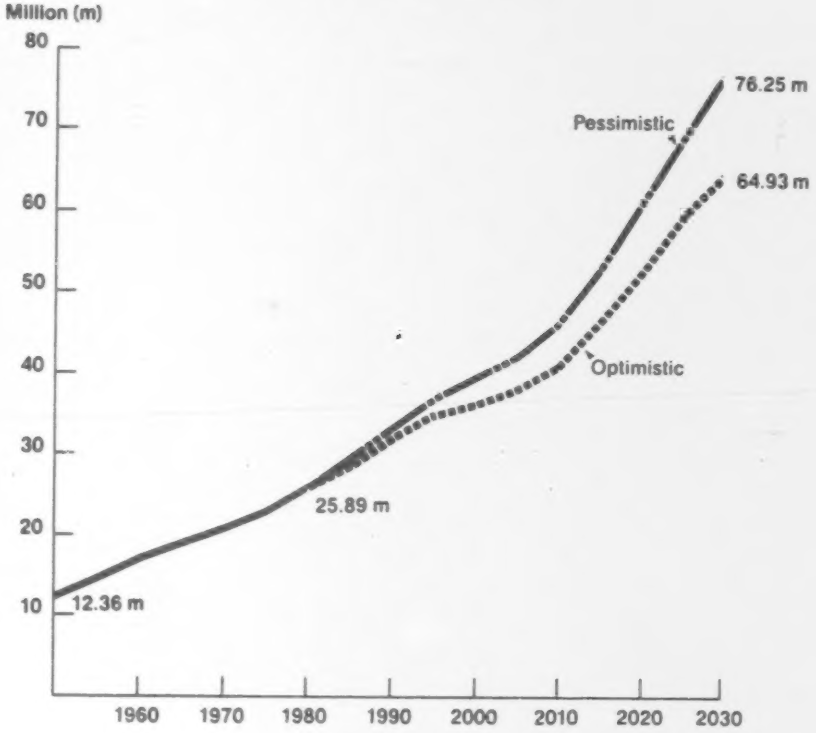
MEDICARE GROWTH SINCE 1972



18.

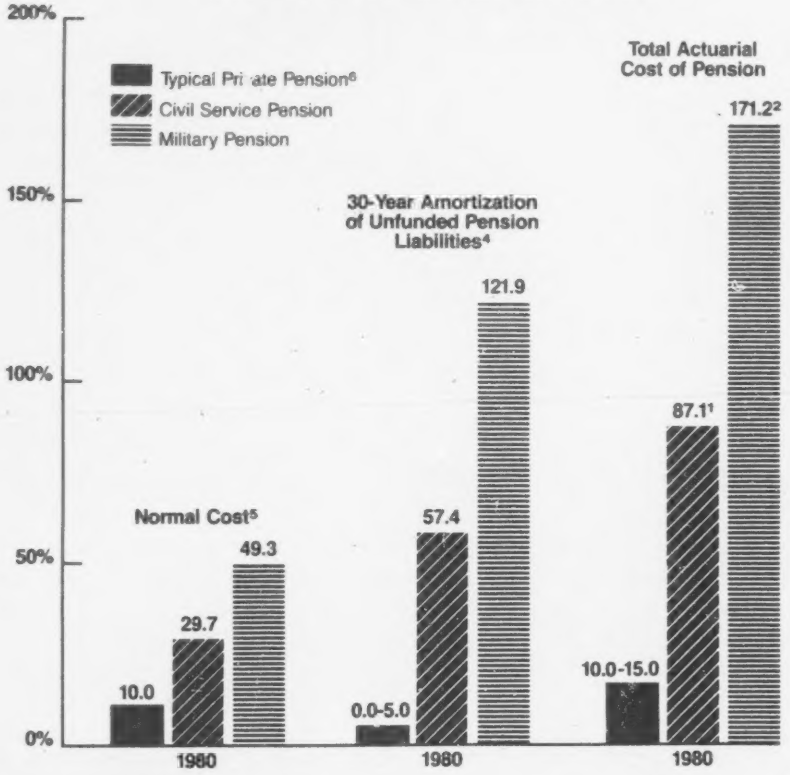
The Growth in Recipients: What Is Happening To The Size Of Our Elderly Population?

POPULATION AGE 65 AND OVER



Pensions: Private Sector vs Federal Civil Service and Military

FUNDED AND UNFUNDED ACTUARIAL COST AS A PERCENT OF EMPLOYEES' PAYROLL[3]



[1] of the 87.1% total actuarial cost, 7.0% is funded by the federal government from payroll taxes, 30.7% is funded from general revenues, and 49.4% is unfunded.

[2] of the 171.2% total actuarial cost, 61.2% is funded from general revenues and 110.0% is unfunded.

[3] if the current and unfunded liabilities of civil service and military pensions were funded over 30 years, as many companies do under ERISA, additional cost would be about $115B per year.

[4] in 1980 civil service total unfunded liabilities grew by $66B and military grew by $75B.

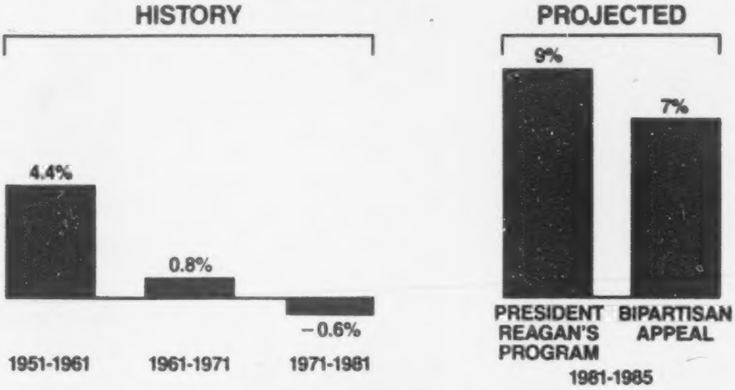
[5] average rate at which contributions would have to be made for each employee, yearly throughout his career, in order to actuarially fund all retirement benefits.

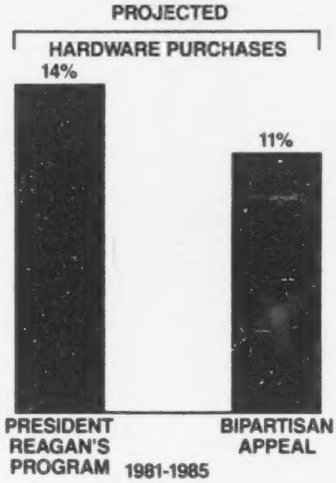
[6] 10% normal cost chosen here is at the high end of the 7-10% average for Fortune 500 firms; employer social security contribution is excluded in order to make data comparable to military-civil service programs.

1985 Deficit
Reduction
Target
$25B

2. Defense

Real Growth in Defense
(Average Annual Rate)

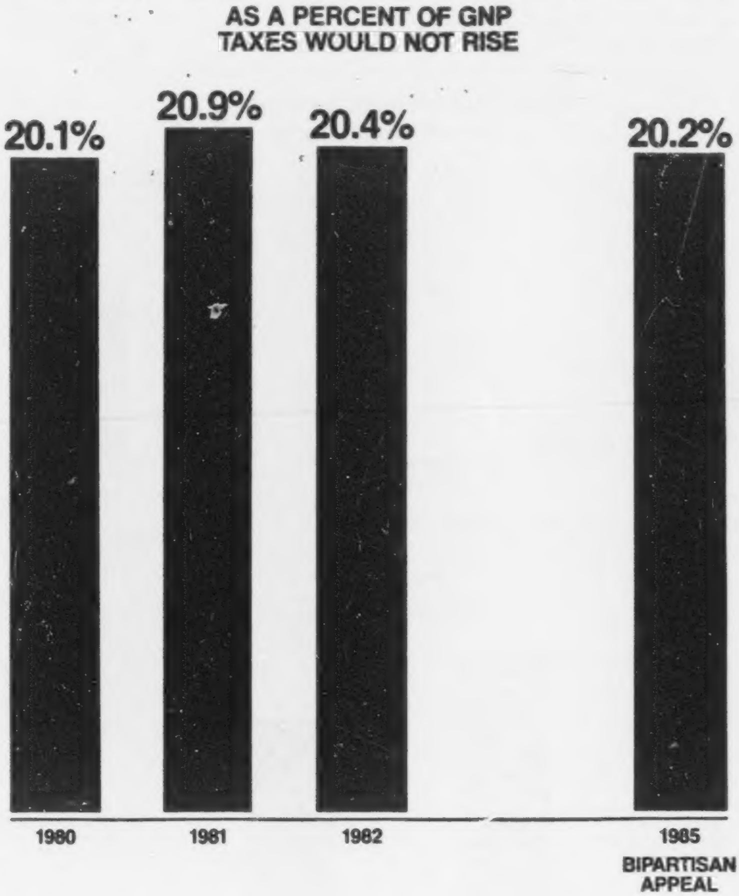




Source: Federal Reserve Bank of New York
Department of Defense

21.

3. Taxes (PRINCIPAL SOURCE—CONSUMPTION BASED TAXES) **$60B**



Federal Grants-in-Aid to State and
Local Governments1/
Baseline Projections Under Current Policies
(By fiscal year, in millions of dollars)

	Projection 1985
Need Related	
Block Grants for Special Education Needs2/	3,388
Human Service Block Grants	3,017
Temporary Employment Assistance	0
Employment and Training Assistance	4,584
Subtotal, need related	10,989
Not Need Related	
Federal-aid Highways Trust Fund	9,420
State and Local Government Fiscal Assistance	5,124
Community Development Grants	3,887
Environmental Protection Agency Construction Grants	3,265
Urban Mass Transportation	3,943
Services to Selected Groups	2,741
Education for the Handicapped	1,137
Unemployment Trust Fund: Training and Employment	912
Vocational Adult Education	839
Impact Aid, School Assistance in Federally Affected Areas	505
Community Services Administration	0
Energy Conservation	442
Airport and Airway Trust Fund	495
Bureau of Land Management Permanent Appropriations	644
Commodity Credit Corporation	310
Economic Development Assistance Payments	261
Urban Development Action Grants	586
Work Incentives, Health and Human Services	304
Federal Payment to the District of Colombia	501
Funds Appropriated to the President: Appalachian Regional Development Programs	219
Law Enforcement Assistance	96
Extension Service, Department of Agriculture	381
Environmental Protection Agency: Abatement, Control and Compliance	409
Forest Service Permanent Appropriations	329
Internal Revenues Collections for Puerto Rico	280
All Other (miscellaneous grant programs less than $300 million)	5,626
Subtotal, not need related	42,658
Grand Total	53,647

1/ Does not include grants that are used for benefit payments to individuals (for example, medicaid).

2/ Formerly compensatory education for the disadvantaged.

Table 1

Benefit Payments to Individuals (Need Related)
Baseline Projections Under Current Policies
(By Fiscal year, in millions of dollars)

	Projected 1985
Entitlements	
Medicaid	23,736
Child nutrition	3,894
Funds for strengthening markets	370
Special supplemental food progrm (WIC)	1,141
Assistance payments program (AFDC)	6,953
Supplemental security income	8,672
Payment where credit exceeds liability	1,004
Veterans Administration, pensions	3,898
Subtotal, entitlements	49,668
Not Entitlements	
Subsidized housing	10,030
Low-income housing	1,544
Other housing	50
Food stamps	12,232
Special milk	36
Food donations	162
Refugee and entrant assistance	680
Energy and emergency assistance	2,063
Student financial assistance	3,875
Subtotal, not entitlements	30,672
Total, need related	80,349

Table 2

Benefit Payments to Individuals
Baseline Projections Under Current Policies
(By Fiscal year, in millions of dollars)

Entitlements	Projected 1985
Social Security retirement and disability	198,769
Medicare (Hospital Insurance)	47,493
Medicare (Supp. Medical Insurance	24,810
Railroad retirement	6,496
Retired pay, defense	18,100
Civil service retirement	26,060
Special benefits (federal employee) retirement and disability	472
Other government retirement	738
Veterans Administration, compensation	12,000
Unemployment compensation	27,230
Student loan insurance	4,158
Veterans readjustment benefits and education	1,059
Coal miners, special benefits	1,096
Black Lung disability	684
Special workers compensation	48
Veterans Administration, burial benefits	151
National service life insurance	1,002
U.S. government life insurance	55
Subtotal, entitlements	370,421
Not Entitlements	
Indian health service	688
Indian health facilities	58
Health services	319
St. Elizabeth's hospital	102
Construction of St. Elizabeth's hospital	6
Alcohol, drug abuse, and mental health administration	0
V.A. medical care	7,786
V.A. construction, major	616
V.A. construction, minor	115
Subtotal, not entitlements	9,690
Total, not need related	380,111

Other Operations and Subsidies
Baseline Projections Under Current Policies
(By fiscal year, in billions of dollars)

	Projections
	1985
Civilian agency pay	30.9
Commodity Credit Corporation	7.0
International Affairs	13.0
Other	8.1
Total	59.0

Source: Congressional Budget Office
Federal Reserve Bank of New York

BI-PARTISAN BUDGET APPEAL NEWS CONFERENCE

Federal Room,
Capitol Hilton Hotel,
16th and K Streets, N.W.
Washington, D. C.

January 19, 1983

PROCEEDINGS

... 10:38 a.m. ...

MR. PETERSON: Ladies and gentlemen, welcome to the Bi-Partisan Appeal to resolve the budget crisis.

I would like, first of all, to introduce some of our supporters from the Washington area, which as you will see are a very bi-partisan group: Secretary Brock Adams, Sheldon Cohen, Former Commissioner of Internal Revenue, and Andy Brimmer, Federal Reserve Board, Bob McNamara, Secretary of Defense and Head of the World Bank, Fred Bergsten, Chairman of the Institute of International Economics and Assistant Secretary of International Economic Affairs, my successor, Fred Dent, Secretary of Commerce and Special Trade Representative, Dr. Hackerman, the president of Rice University, Elliot Richardson, who has been secretary of so many things, I won't take the time —

...Laughter...

MR. PETERSON: -- to cover it.

Admiral Zumwalt, we welcome you, sir; Jim McIntyre, Former Director of the Office of Management and Budget; John Macy, Chairman of the Civil Service Commission, a leading expert on civil service pensions, which we will be talking about; and, of course, Elmer Staats, a thoroughly bi-partisan gentleman, former Comptroller General.

First of all -- and I will be introducing my founding member colleagues in a moment -- I would like to say a few words about the spirit in which this group has been founded.

We are well aware of the fact that from time to time there are special interest groups that come to Washington. Often, they are asking for something...whether it is more benefits, or more subsidies or more protection or more something, I would like to think we are not such a group.

There are other groups that may be out to embarrass one political leader or another. We are certainly not here to do that.

We would like to believe that we are here representing the general and long-term interests of the country.

We want nothing for ourselves. But, we do want a great deal more for our economy and our society. All of us share one thing in common: We are clearly worried about the future of both.

Perhaps it would make sense to read just a paragraph from the letter to the President, to the Speaker of the House and Senator Baker. We want to be clear about the spirit of the effort.

We say in this letter "The appeal is made in an entirely constructive spirit. We are not pointing fingers or assigning blame. Today's fiscal and budgetary crisis has deep roots in every administration and Congress which has served over the last 20 years or more, including those of which we were a part. Both as former public officials and leaders of the private sector, we must, ourselves, accept a measure of the responsibility for the immense structural deficits which have been embedded in the Federal budget."

I would like to emphasize that many of these problems are bi-partisan in origin. They had bi-partisan support. We have been avoiding them on a bi-partisan basis. And we think they must be solved on a bi-partisan basis. That is the spirit of this group.

A word about the current status of the group:

As you can see, we now have about 500 members from both parties and many walks of life. We are now talking to other kinds of organizations, farm organizations, small business organizations, youth organizations, home builder organizations and others. We want the support to broaden.

We now would like to take you briefly through a presentation of our material. I will then ask each of the founding members if they will say a few words about certain specific areas and whatever else they wish. Then, of course, we will be available for questioning.

First of all, let's talk about the problem. The problem is obvious: unprecedented, unending, growing deficits. I would even call them grotesque deficits. We will show you today our estimates of their approximate size under various economic assumptions.

Secondly, there is a growing mismatch between revenues and spending. We will show you today how big and how structural we believe that mismatch is. We have the problem of draining an already limited savings pool that threatens to become a puddle, or even a desert.

We will show you today how much of the Nation's already inadequate savings would be drained if we permit these deficits to happen. The problem of robbing critically needed investment in our economy's future will receive a good deal of attention today. People often ask about Japan's superior economic performance. I'm reminded that Japan is a country without oil, without resources, without much food. If you look at all the explanations, certainly there is one that almost everyone agrees is one important explanation; that country has not mortgaged its future. It has invested in it.

For example, in new plant and equipment, as a net percentage of GNP during the decade of the 70's, the Japanese invested 9.8 percent of their GNP. We invested 3.4 percent. That country now has two-thirds or more of all the robots in the world. Their plants are about half the age of ours. That comes from a much larger level of investment in productivity, enhancing equipment and plants.

Many of you perhaps know that they are now spending, relatively speaking, about 20 percent more than we on R&D for commercial purposes. You may not have caught up with the fact that their investment in scientific, education and technical training now far surpasses ours. At the elementary science levels, it would appear they are investing three to four times as much as we are in this area. In the high school areas, we are told that 30 percent of the high school graduates have calculus; 30 percent have some computer-related instructions, compared to 3 to 4 percent in this country.

You may not know, in view of our rather recent concern for public infrastructure -- which, in its way, encourages productivity — that the Japanese economy during the decades of the 70's invested 5 percent net of its GNP on public infrastructure, seven times as much as did this country, .7%.

So wherever we look, we see an economy that is investing in its future.

I told you I would show you the unprecedented, unending growing deficits. We thought you would be interested in some history of these deficits. We go back to the fifties and to the sixties. You will see that during much of the sixties the average deficit was 1 to 3 percent of gross national product. These shaded areas are the recession where there is a lag before deficits go up. What makes our current situation unique, is that for the first time, we not only have record deficits and growing deficits, but we have deficits that are at unprecedented levels in a period of 3 years of growth, in peacetime of 6, 6-1/2, or even a higher percent of the Gross National Product. Our base case assumes 3 to 4 percent real growth.

We have heard recently that we can grow our way out of these deficits. The people that have been helping us with our numbers have estimated that even with 5 percent real growth for three straight years, the deficits will be in the range of $200 billion.

So I think it is not an unfair characterization to say that these out-year deficits are truly structural.

I told you we would discuss with you the growing mismatch between revenues and spending. The shaded area is what you might call the deficit gap. You will see, of course, here, a significant reduction in the share of the

GNP revenues, down to 18.7 percent in 1985. With the indexing of the tax system in 1985, of course, the revenues will tend to flatten out as a percent of the GNP.

However, when we look at the latest spending estimates that we have been able to make based on the actions taken to date, clearly we hope that much more will be done. Federal spending trending up in the range of 25 percent of the Gross National Product. What we are facing here is deficits, in the context of three growth years of 3 to 4 percent, which, in turn, leads to our assumption of a deficit of roughly 6-1/2 percent of the Gross National Product.

I indicated earlier that one of the reasons that we are not doing well, in our opinion, is that we have been mortgaging our future instead of investing in it. The American people have been told through a kind of ritual that we go through every year or two that we now have an "official debt" of $1 trillion. We do not believe that the American people understand -- this trillion dollar number in itself is hard enough to understand -- the magnitude of these unfunded liabilities -- commitments that have now been made in excess of revenues that are provided -- are now about $5.6 trillion in the case of Social Security and nearly $1 trillion for the government's Federal civil service and military pension programs. Under our accounting system, as Mr. John Macy can speak on with great authority, of course, are not accrued, but those bills will nevertheless be coming due.

It is this prospect of enormous future bills coming due that are signalling to the financial market that these deficits are not going to go away and will probably get larger unless we attack some of the underlying forces.

I told you that one of the other problems is the way these deficits are soaking up savings. We already have a very shallow savings pool. None of us are satisfied with the performance of our economy in the seventies, where we virtually achieved zero growth in terms of real income per worker, however inadvertently.

First, let us look at the decade of the 60's and the 70's. You will see the total flow of savings in America, both personal and business, subtracting from that the financing of the deficit, and allowing for depreciation, we ended up with about 6 percent of the Gross National Product in the 70's, about 7 percent in the 60's that was available for net new investment.

If we try to finance a deficit of 6-1/2 percent of GNP, you can see that the amount available for all investment in America, at a time we are in an increasingly competitive world which suggests we should be investing more, not less, we would have half as much available for investment, thereby threatening -- some would say assuring us of almost perpetual stagnation. If we achieve the 1985 deficit goal of $75 billion, you will see that we can at least get back into the ranges that we had in the previous two decades.

You will hear Joe Fowler talk a bit about the form of taxes that we propose. I simply want to make the point that if the only way we are going to fund this deficit is to reduce the very savings that are already inadequate, we will not have really contributed to the solution of the need for more investment in our economic future. So, we argue that the form of these revenue increases is extremely important.

You have heard a lot about federal deficits crowding out private investment. I don't know how many of you follow these numbers. We thought you would be interested in seeing what $200 billion of net new federal borrowing amounts do vis-a-vis what the other sectors of the society of the economy are borrowing. This is not a $250 or $300 billion deficit, but far less.

This $36 billion on the chart is the private sector's, corporate net new borrowing. This is obviously where most of the jobs are created, where we think we need more investment. You can see what the numbers are, well over 2/3rds of the total of the net borrowing amounts will be taken up by the federal sector.

We have here, it seems to us, a Catch-22 situation. With deficits this large taking up so much of our available savings pool, the problem that we face is this: at the time that this private sector starts rebounding, starts needing more capital, starts growing, then we have the private sector and the federal sector competing for a very inadequate savings pool to start with. This makes the very recovery more tepid and more temporary than it would otherwise be.

We are concerned, as nearly everyone is, about unprecedented levels of real interest rates. We believe that these unprecedented levels of real long-term rates, which will have a series of effects that we will discuss with you, are clearly related not simply to the collision between tight money policy and loose fiscal policy but to the market's uncertainty and concern about the Government's long-term budget policies.

We have forgotten that there have been periods where we had minus real interest rates. There have been other periods where we have been zero, 1 percent, 2 percent real interest rates. We are now looking at real interest rates of about 6 percent, which are extraordinarily high and which we believe have greatly exacerbated the serious economic situation that this country finds itself in.

Let us cover briefly the effects of these real interest rates. You need not have me tell you that we are in a near depression in many of America's basic interest sensitive industries; in autos, in housing, in construction, in durable goods. These industries, in turn, depress the demand in other basic industries, and they clearly depress the demand for capital equipment which we had hoped would be stimulated.

You read in today's newspaper about one of America's great companies, Caterpillar, which most people acknowledge, has done many things right, lost $200 million in the fourth quarter, brought about partly by the domestic situation and, importantly, as we will see, by an over-valued dollar and a deteriorating U.S. export situtation.

I needn't remind you of why getting real interest rate returns of this amount discourages investment, capital formation and jobs creations.

The over-valued dollar is a subject that most Americans don't know much about. We tend to leave that to the financial gnomes around the world. It is clear, however, that the overvalued dollar is having enormous negative effects on jobs and exports. Fred Bergsten, the Chairman of the Institute of International Economics, has done a study in which he has tried to estimate what the lost job opportunities have been, due to the over-valuation of the dollar and the deterioration of our net export position. One can conservatively say that we have lost 1 to 2 million job opportunities. What is not widely known is if you look at the drop in real GNP between the first quarter of 1981 and the last quarter of 1982, 3/4ths of that can be associated with the deterioration in our net export position, which is more than the drop in housing or autos. This is a critically important aspect of the current economic malaise.

Again, you need not be reminded of the level of bankruptcies in America, not just in businesses and farms, but all over America. We have all read of the growing number of bankruptcies in rural America, which I know saddens all of us. It is also clear that because of these very high long-term real interest rates, the balance sheets of too many of America's companies are fragile with too much very short-term debt. These companies are unable or unwilling to fund their debt long-term the way they should in order to be able to take the long-term risks that growing companies should take.

Mike Blumenthal will spend a moment on the interrelationship between these high-level real interest rates, the developing countries, the world economy, and the fragile global financial system. There is nothing we could do to help the world economy more, to lessen the risk of some kind of financial aneurism, than to get our fiscal house in order and get these real interest rates coming down.

Obviously, all this results in unacceptably high unemployment, virtually as a fixed feature of the industrial landscape. We are now talking casually about levels of unemployment for several years that would have been unthinkable in previous times in America.

You don't need me to repeat one more melancholy set of numbers.

Let's now get into the principles of the budget reform and why this group has defined these principles as we have.

You will notice that we talk about focusing on the long-term — 1985 and beyond. What we believe is desperately needed is persuasive action, taken soon, that these out years' structural deficits are finally being addressed in a substantial way. The 1983 deficit is, in significant part, a reflection of today's recession. These out-year deficits, as we have already indicated, are not a reflection of a recession. It is those long-term structural deficits that must be addressed.

Another basic principle is to focus on spending, particularly programs of subsidized consumption. Alas, it is an inevitable piece of economic arithmetic that if you are going to save more, you must consume less.

It is particularly important, we think, that we focus on spending programs that subsidize consumption, particularly for the middle and upper income groups where substantial amounts of this subsidized consumption are taking place. Bill Simon, who is with us in California, will have a few things to say about that.

We have already made our point about promoting investment.

I would like to be clear on this last principle of fairness. A number of people have asked our founding members, "How were you able to attract such a broad, bi-partisan spectrum of Americans, a group of strange bedfellows who don't always or even often agree on various subjects?"

What we have discovered is something that we should have expected, given the basic sense of fairness in the American people: That there is a broad commitment in America to do something meaningful about the problems of the poor.

In that spirit, we have looked at the pattern of budget reductions. We believe the time has come for a wider and fairer sharing of those burdens. We also know that nothing is more important for anyone committed to the poor than getting the economy growing again.

What is the goal of this effort? We hope we have set a backdrop by which we can rationally decide what a goal should be.

As large as this number seems, and, indeed is, we believe that to make the kind of really, meaningful attack on this problem that is required to get our economy growing again, long-term, it takes a cut of about $175 billion. We want to get the deficit to less than 2 percent of GNP, heading toward balance. If you look at the nominal GNP that results from 3 to 4 percent real growth, 2 percent GNP, is almost $75 billion.

Since it is our estimate that the deficit, with all current actions, will be about $250 billion, the melancholy goal, but, we think, the realistic number, is a $175 billion reduction for 1985.

Now, to give us and our group a sense of perspective, we thought it would be useful to assess all of the budget actions to date so that we could fairly and accurately understand what has happened.

We have talked a great deal about cuts in the budget. Where in the budget have there been actual cuts in dollar terms? Clearly not in defense; not in means-tested benefit payments; certainly not in non-means-tested benefits. But, there have been dollar cuts in absolute terms in grants to state and local governments which, of course, are creating pressures there for infrastructure and other state taxes, and there have been cuts in the category in other Federal operations and subsidies.

The next chart tries to take all the budget actions and translate them into a share of our Gross National Product. Where in the budget has the GNP share declined?

Here, we can see that the means-tested benefit payments, that is, those in which income of the recipient is an important criterion, have been reduced somewhat as a percent of the GNP.

In the non-means-tested programs, which are a very important target of our efforts, that is, the programs that do not have income as a principal criterion, you will notice that they have gone up significantly as a percent of the

GNP, and are one of the driving forces upward as, indeed, is defense. You will notice, as before, grants to state and local governments and other operations are down significantly.

You will also notice a grotesque increase in interest expense. Interest payments of this magnitude would be taking over 1 percent of the entire GNP of the country, or about $120 billion at the official interest assumptions.

So the cuts in share and/or dollars have been in these three areas.

I call your attention to a footnote. We have tried to study the pattern of budget reductions that have taken place to date. It is of interest that the cuts in these means-tested programs, which have income as a test, have been 10.1 percent. The cuts in the non-means-tested programs, that is, where income is not a test, are only 4.7 percent. It is for this reason, among others, that we suggest that both simple equity and simple arithmetic requires that there be this wider sharing of burdens and that the much larger non-means-tested programs must be addressed.

This leaves us with a perfectly brilliant insight that we have nowhere to go for really large reductions but in these non-means-tested entitlement programs and defense.

First, let's take our goal in relation to the entire Federal budget. If we are serious about reducing the deficit by $175 billion, it is clear that this is 17 percent to 18 percent of the entire budget. If we then look at where the cuts have been or where the reductions in growth have been, and then look at three areas, defense, non-means-tested benefit payments, and net interest, you will see that they account for 80 pecent of the budget. It is for that reason that we have said it is arithmetically, it is fiscally, it is ethically impossible to resolve this budget problem unless we address these indexed, non-means-tested entitlement programs.

I want to state a brief caveat. While this group is focusing on getting our fiscal affairs in order, many of our supporters -- probably all of us -- are aware of the fact that this is, in and of itself, not a total, comprehensive program for economic recovery. For example, many would favor changes in monetary policy, particularly in the context of a tighter fiscal policy. Others, many, believe that Social Security and Federal pensions must be thoroughly restructured long term. Many believe that we must do a lot about scientific education, research and development. Many believe that we have to change our tax system toward more savings and capital investment. Clearly, there is a growing understanding of the need for rebuilding public infrastructure. We have only begun to think through, to even conceptualize the problem of what happens in a world of information, of knowledge, technological sensitive type competitive developments; of how we educate, train, indeed retrain workers. The exchange rate system, many would argue, needs to be reformed. Indeed, some of our current problems are related to the trade-related valuation of the dollar. There are some who believe our export policies need to be reformed. There are other areas.

But if there is one thing that unifies this group, it is that any such measures are not going to be effective without basic changes in the budget policies of this country; it is the fundamental that cuts through most programs. For example, many who would like to see an easing of the monetary policy argue that going with that should be a much tighter fiscal policy; thereby avoiding the collision of fiscal and monetary policy that our advertisement refers to.

Now, if we can go through our program briefly. The bi-partisan program of a $175 billion cut in the 1985 deficit is $60 billion in entitlements, and other non-defense programs; $25 billion in defense and, in the context of having achieved these spending reductions which we believe should assume the first priority, we believe that we will need, as painful as it is to say this, something on the order of $60 billion in tax increases in 1985 if we are serious about this kind of deficit reduction. Along with the roughly $30 billion in savings in interest costs that would come from that, you can see that we achieve our goal of a $175 billion 1985 deficit reduction in that way.

Now, the reductions in the entitlements and the other non-Defense programs of $60 billion in 1985 include a variety of possibilities: a one-year freeze on the cost of living adjustments for the major entitlements programs, Social Security; Civil Service pension, military retirement and so forth. We agree that there must be a cap on the indexing thereafter. We include several possibilities. As to the possibility of the 60 percent of the CPI indexing factor, the founding members were talking earlier this morning about indexing. We are reminded that, in the only opinion study that I have seen of the American people's understanding of indexing, one by the Gallup organization, the results go something like this. Very large numbers of Americans don't even understand that these vast programs are indexed. Very large numbers do not understand that they are indexed automatically. When they are told that there is indexing and asked what kind of indexing, the majority of Americans, I believe, indicate that they would like to see year-to-year indexing decisions that are made in the light of circumstances of our capacity to afford them. Finally, when people are asked, "If there is going to be automatic indexing, what kind do you prefer?" As I recall the study, the majority say, "Well, since the wage contracts are escalated as a certain percent of the COLA, perhaps the recipients who, after all, get the money from the wage contributions should be indexed accordingly." As you know, those wage escalators tied to COLA's often have a 60% of the CPI factor.

There are a variety of things that could be considered, but we don't know of any way of getting this budget under control without putting a cap on indexing, or reducing the rate of indexing.

There are other restraints and reductions in subsidies in other programs that are also essential to meeting this goal. Again, we believe we can -- and I think all of us would agree we must -- carry out these measures in ways to protect the citizens truly in need. There are a variety of ways of doing this, if the will exists. For example, on indexing, those with the lowest wage histories can be protected. We can beef up the supplementary security income. A commitment of this group is to reaffirm this country's commitment to the poor.

We should talk a bit about the Social Security situation since, clearly, it is a subject on everyone's mind. Needless to say, since the agreement was reached over the weekend, our 500 supporters have not had a chance to caucus or consider what the full implications are, so each one will have to speak for themselves on that.

We have tried to put together some preliminary numbers to ensure that these changes are in perspective. Perhaps I should share with you at least our preliminary analysis of what has been done by the Bi-Partisan Commission. In making these comments, we want to respect and indeed be grateful for the very hard work, and for the fact that some improvements have been made. At the same time, we want to also be sure that we put these changes in the context of the magnitude of the budget problem that this country is facing.

In terms of plusses of the Commission's recommendations, as our group, at least, analyzes this, one can be grateful for the fact that it is something that is like to be quickly enacted. Many of the other alternatives would have probably not been enacted for some time. Therefore, we can clearly be grateful for that.

The not so good news, I guess, is that as we, at least, estimate the savings to the overall budget deficit, it may be substantially less than it appears to be. We are concerned, as you can tell, with balancing the books of America, not with balancing one part or two parts of the Social Security system. To give you an idea of what the impact of those changes might be on the 1985 deficit of $175 billion target, it would appear that the effect on the 1985 budget deficit is somewhere between $8 and $9 billion. Now, clearly, if we are going to get $8 to $9 billion out of the government's biggest program, by far, we have got a long way to go somewhere.

It has been said that there has been a contribution of $169 billion to the solvency of the Social Security system. Again, given our focus on the effect of the overall budget deficit of all our fiscal pockets, as it were, it would appear, at least by our first estimates, that the actual effect on reducing the budget deficits is not $169 billion but something like $90 billion. In 1985, the net number would appear to be somewhere between $8 and $9 billion, as I said.

So, what we are looking at in terms of the kind of deficits we are talking about is that in the period from 1983 to 1989 is some number like a $90 billion net reduction over seven years. It is certainly gratefully accepted, but we should not overstate its contribution to the magnitude of the problems that we are talking about.

It seems to us that you might be interested in why it is that the savings in the unified budget may not be as much as they might appear to be in the context of the $169 billion package. You will notice that for the first time, the proposals extend the coverage to newly hired Federal workers. We think it is important to remember, however, that in lieu of these Social Security tax increases for newly hired workers, they would have been paying seven percent of their pay anyway toward Federal pensions, which they will now not be doing. So the effect, obviously, on the total budget deficit is virtually offset.

There is a discussion of the Social Security tax increase and its acceleration. That, clearly, will be helpful in terms of deficit reduction. Again, it isn't quite all of what you might expect for two reasons. Remember that business deducts 50 percent of their increased contributions, so that is a loss in revenues to that extent. Remember also, that in 1984, there is a one-time, dollar for dollar refundable credit of $4.6 billion. So that reduces the net effect on the budget deficit somewhat.

You should also be sure to remember that there is a one-time reimbursement in this proposal from the Treasury or the General Fund to the Social Security Fund in which the Social Security Fund is compensated for benefits to military service personnel who contributed nothing to the plan before 1957 but who are now receiving payments. It is a one-time payment that admittedly, may help the short-term solvency of the Social Security system, but it does not make a net contribution, as you can appreciate, to reduce the deficits of the country since those bills must be paid in the future.

Now I suppose we should look at other aspects here and be sure we have a balanced appraisal of this effort. Benefits are to be taxed. Speaking for myself, I think that this positive development is long overdue. People are getting back much more than they put into Social Security, and substantial amounts go to people in higher income groups. Frankly, I have never understood why we should not pay taxes on all the amounts in excess of what we have contributed, not half, but all of them, and about 80 to 85 percent of what is contributed is in excess of our original contributions. So at least it is a start in a rational direction of taking some of the welfare and subsidy out of this program.

I think we would all welcome the delay in indexing of six months. It is clearly much better than nothing. And who knows, six months and another six months, would equal a year. It amounts to something like $4 to $5 billion a year. One of the reasons for our proposal of a one-year freeze is its reminder that between 1979 and 1981 most studies would indicate that the indexing that was paid to the beneficiaries of these entitlement programs went up almost 10 percent faster than the personal consumption deflator, and a 10 percent reduction, which would bring these people even, so to speak. Thus, our proposal would result in a number much closer to $15 to $20 billion for a period of several years.

I think another development here -- at least it's gone on the agenda, however tentatively -- is the issue of indexing. You will remember that under the proposal, not until 1988 and only under certain contingencies, that is, if the Trust Fund gets itself in solvency difficulties, there can be -- there would be, under those circumstances, indexing to wages or prices, whichever are lower. However, as you can tell from my earlier comments, we doubt very much that long-term, this indexing change is really adequate in the context of the overall deficit problem of the country.

I think another positive development is that, as I understand it, the majority is talking about the possibility of increasing the retirement age. I am sure you all know that since the system was founded, a person aged 65 now has a life expectancy of about four years longer than was anticipated at the outset. In my judgment, at least, any balanced program of long-term reform must include the gradual increase in retirement age.

Perhaps the most serious question that we want to be sure that the American people understand, before deciding that the solvency of the system has been guaranteed for the next 50 years or so as I have been reading lately, is to remind you that the Commission did not include the Medicare problem as part of its reform of the Social Security system. Most estimates that we have looked at suggest that Medicare, in the long term, could equal 75 to 80 percent of the deficits of the system. For some years, we have assumed the problem away with optimistic assumptions. I would hope we don't now assume the solution away of what has to be one of the most difficult, wrenching set of issues, fiscal, social, ethical and otherwise that this country is going to face... Medicare costs, really health costs.

Let me just remind you about what has been happening in Medicare. During the period of the 70's, due to demographics, there has been little increase in beneficiaries, but the Medicare program has nonetheless been the fastest growing program of all due to an absolute explosion in the disbursements per beneficiary. Last year, for example, hospital costs went up about three times the overall rate of inflation in the society. Now, if we look at this kind of growth and examine what might well be happening in the next 30, 40, 50 years to the growth in numbers of recipients, here is what we see in this chart. I won't bore you or confuse you with the sordid and somewhat perverse characterizations of "optimism" and "pessimism" in the world of Social Security. I guess it is optimistic to have lots of babies and to die soon; and it is pessimistic to die sooner and not have so many babies. But, whether you are pessimistic or optimistic is irrelevant. Out here, 40, 50 years from now , we are looking at a demographic profile of America going from 25 million to 65 million to 75 million beneficiaries over the age of 65. What we need to be concerned about, of course, is a situation in which the disbursements per beneficiary go up, and then that is multiplied by a rapid growth in beneficiaries as well.

I don't think it is an overstatement to say that in view of what is happening in medical technology, costly technology also, in view for example, of what is happening with Dr. Clark in Salt Lake City, some of the most wrenching questions this society is going to have to face is, "How much health costs are we willing to absorb? And not only how do we absorb this, but how do we fairly allocate health services to our citizens, and how do we get these health services more efficiently?"

Medicare will raise some of the deepest political, ethical questions I can imagine. But I think it is important that the American people understand that no one claims, whatever their assertions about the solvency of the system, that this medicare problem has been dealt with.

We think of it, therefore, the Social Security reform, as a first step, and if we think of it as a first step and a constructive step that is fine. But if we think of it as a final solution for the next 50 years or so, as I have been reading, I get concerned. I saw a musical in New York the other night, "One Mo' Time". One More Time, we will have given the American people a sense of false security about Social Security. It seems to us, therefore, that it is important that these constructive steps be put in the larger context of the total problem.

You will see us talking increasingly as our Bi-Partisan program goes on about Federal pensions and military pensions. John Macy is heading an admirable effort as an ex public servant who chaired the Civil Service Commission, on the question of Federal pensions. The American people, in our judgment, have very little concept of how bloated and large these pensions are and how large these unfunded liabilities are, now pushing a trillion dollars.

So, for purposes of this meeting, we thought we would put together some numbers for you on federal pensions so that you could begin to focus on this problem.

The normal cost, so to speak, compares a private sector pension in one of the top 500 companies, a Civil Service pension and a military pension. This chart assumes that the costs were covered in a normal way in which you started from the beginning and you funded the pensions properly. You can see that the top of the range for top 500 companies was about 10 percent of pay. It runs 7 and 10 percent plus Social Security. The Federal pensionees are about 30 percent. The military about 49 percent. But, alas, that is only the current costs. We have got this nearly trillion dollars of unfunded liabililities, bills that are coming due; as these pensions are now constructed, these are commitments that need to be made.

We thereby made a calculation of what it would take to fund these pensions on the same basis, under ERISA that the private sector of America funds its pensions, say over 30 years. We talk about comparability in pay. We think it would be relevant to have comparability in the treatment of the pensions, indeed in total compensation.

This adds 57 percent of pay not reflected in the budgets and 122 percent in the case of the military.

If you add these all together, you see a private pension cost of 10 to 15 percent. You see 87 percent and 171 percent here on the civil service and military pensions respectively. Not to present you with one more melancholy number, but if you are interested in knowing how much more would be added to the costs if we were to fund this pension system in the way that the private sector funds its pension system, we estimate it would add about $115 billion a year to our expenditures.

It is essential that the American people understand the magnitude of these unfunded liabilities.

Next is defense. John Connally will have a word or two to say about that. All we have tried to do here is indicate what our program does in terms of historic growth in defense expenditures in real terms, in terms of the President's original program. You can see what happened in the 50's, the 60's and the 70's. You can see that we would still have a 7 percent real annual increase in overall and 11 percent compounded annual increase in hardware purchases.

The issues on defense can be better addressed by Elliott Richardson, Harold Brown, David Packard and Bob McNamara, others who have joined our group. I think one of the obvious issues is: Can we spend this much money wisely? I will leave that to people who are more expert than I. Some of the rest of us who are not defense experts argue along certain additional lines.

We believe that a sustained and strong foreign policy requires a strong economy. Therefore, it is very difficult to imagine a situation in which this country, vis-a-vis the rest of the world, could continue on its current economic path and continue to have the kind of strong foreign policy in all of its aspects that it should have.

Third, many of us on this platform have negotiated with the Soviet Union, including myself. I would argue that I would rather confront our adversaries and assure our allies with a credible, sustained, long-term buildup in defense that they believe would be sustained because the economy would sustain it, and our politics would sustain it and support it on a bi-partisan basis. That is the strong basis on which we should negotiate with the Soviet Union on the critical subject of arms control.

Finally and very important, in our judgment, given the political vectors of America and given the extraordinary difficulty of attacking frontally these vast entitlement programs that are non-means tested, we find it very hard to believe, if we understand the political matrix of America, that it will be possible to get anything like these kinds of cuts that are absolutely indispensable in the non-means-tested entitlement programs, if one area or the other is a sacred cow or off limits. It is essential, therefore, that, in our judgment, the defense effort make its reasonable contribution, while still assuring us of a sustained buildup.

Finally, and last, and clearly last, we believe that the problem is so large that, assuming that the indispensable spending cuts are made, we will still be in a position where we must do something to increase revenues. We propose about $60 billion in 1985, again, in the context that these spending reductions are made.

You will notice that the principal source of these taxes that we propose would be consumption-based taxes. Joe Fowler will say a word or two about that.

I would simply indicate, as I alluded to earlier, that we have the most pro-consumption, pro-borrowing tax system in the world, among leading countries, and the most anti-savings and anti-investment. We think if we are serious about investment we must think about the form of tax increases.

I'm sorry for going on so long.

What I would like to do now is ask some of our other co-founders if they might say just a few words, if I have left them any time. John Connally, of course, was Secretary of the Treasury and the Secretary of the Navy. And, one of the founders, I believe, John, of the Committee on the Present Danger, is that right? And certainly someone who has been long identified with the strong defense effort might want to comment, not only on the overall program, but whatever he would like to say about defense.

PRESENTATION OF JOHN B. CONNALLY, SECRETARY OF TREASURY, 1971-1972

MR. CONNALLY: Let's put the Defense chart back up.

I don't think it will serve any useful purpose for me to spend a great deal of time. I think Mr. Peterson adequately and eloquently explained the situation on defense.

You can see what the historical background has been. From 1951 to 1961, we had a 4.4 percent growth, actual real growth in defense. From 1961 to 1971, in that decade, it was 0.8, and then from 1971 to 1981, it was actually a negative, 6-10ths of a point negative.

The President's program for 1981 to 1985 is a little over 9 percent. We are suggesting that in order to reach the overall objectives of the program to reduce the deficit by $175 billion by 1985, that defense bear some of that burden and that the overall program be cut from 9.3 percent to 7 percent. We did not go lower than that for several reasons: I think most of us firmly believe in a very strong defense. As Mr. Peterson said, we think the most creditable defense that you can have, so far as any potential enemies and even our allies around the world are concerned, is to have a defense program that they think can be sustained over a long period, at least until it is achieved. No defense program can be achieved in the term of any four-year term of any one President. Obviously, these purchases that we are talking about here that are running over 14 percent under the President's program, and even under our suggested program of 11 percent, those purchases are not going to be consummated during his present term in office.

Indeed, it runs for a period of time far beyond that in many cases.

So that inevitably, if you are going to have a creditable defense program, then you are going to have to have one that the political situation and the economic situation in the country can sustain. It is our view that however much the purists like to think that the defense program is totally separate and apart from entitlements and other big items in the budget, we think they are inextricably interwoven. That is certainly my view, and I do not think that you can expect to have cuts of approximately $60 billion in entitlement programs and raise $60 billion in new taxes unless you are prepared to take at least a $25 billion cut in the year 1985 in defense.

That is essentially the story. We are not here today to make specific recommendations on how that $25 billion should be allocated in the defense establishment. I think suffice it to say that again in 1985, we are looking at budget expenditures in the range of $275 billion, and we do, indeed, think that by stretching out, by making tough decisions, by establishing priorities, that at least $25 billion can be saved without doing any real damage to the defense program.

MR. PETERSON: Thank you.

Bill Simon is establishing his credentials as being a global traveler. Last time Bill was in London, when we first announced this program in May. Today he is in Los Angeles chairing, I believe, Bill, the U.S. Olympic Committee preparations for 1984, I assume.

Bill, are you with us?

PRESENTATION OF WILLIAM E. SIMON, SECRETARY OF TREASURY, 1974-1976 (VIA TELEPHONE)

MR. SIMON: Yes, I am, Pete.
Can you hear me all right?

MR. PETERSON: We can, and we would like you to say whatever you wish on spending and its priority or anything else you would like to say, Bill. We are delighted you would be willing to do this.

MR. SIMON: I am not in Washington. Your remarks were very cogent and specific, Pete, so I am not going to go into any detail at this time except to give a general overview that we have as to the budgetary and financial crisis of the country. We cannot wait for a resolution any longer. These deficits in the years ahead are going to cripple our economy and leave, for years, financial turbulence and industrial stagnation, high inflation, lead to extraordinarily high interest rates, and, most importantly, a total loss in the eyes of the American people of the desirability to run and have a growing non-inflationary economy.

The nature of this crisis transcends the parties and economic ideologies and all those lines the politicians do use. In the national interests it demands leadership, the leadership of the President, the leadership of the Congress and working together to restore financial sanity.

This is going to require our elected officials to focus on the long-term structural reforms that are required to solve the real fundamental causes of our problems; in other words, to ignore the short-term political considerations of re-election as part of the politics which is a haven of our various statesmen. These are what hold the American people to truth. Let's tell them that we believe sacrifices have to be made by everyone. Tell them that the problem is not going to be solved in just a few months; that it is going to require patience and support and understanding. I can say, without equivocation, that in my more than 30 years in finance, investment, government, that I have never seen a period when the risk on the down side is as great as it is today with the illiquidity of our non-financial and financial institutions at alarming levels. With the international defaults, and we are also aware of domestic bankruptcies at the highest levels and economic stagnation, still too high inflation compounding this with the Federal budget that is dangerously out of control.

We have to examine these in the years ahead, these deficits which are leading 5 percent or more of the Gross National Product year after year. That means that government borrowing is going to devour virtually every single penny of savings. Just think for a moment what this means to job expansion, to productivity and the personal indebtedness that is needed to keep up competition in this world. The result of this economic insanity on the part of the government would be to deny Americans sustained and non-inflationary prosperity for the years ahead.

Indeed, recovery in today's recession is going to be feeble. Interest rates are going to remain quite high; inflation will increase; investments will stagnate. Job creation will be destroyed. Unemployment will remain unacceptably high.

Our deficit problems are manmade. Unless they understand that, they cannot be solved by us. We can put in much needed savings and investment and certainly, it will not put harsh burdens on the poor. To know what must be done is to address the fundamental problems of our runaway deficit which is the growth of entitlement programs, the growth of defense spending and, of course, our taxes.

Please note I am talking about addressing the growth of spending and reducing, not slashing spending as it has been described. Also, most importantly, no area, no area can be a sacred cow. No area can be placed out of attack.

I am asking for what some might consider the ideal. This is a bi-partisan approach to call for a joint leadership on the long-term well being of our country.

MR. PETERSON: Is that it, Bill?

MR. SIMON: Okay.

MR. PETERSON: Thank you. I take it you are suggesting that we are going to have to run a lot faster than we have been and that applies to the U.S. budget process as well as the U.S. Olympic team. Is that right?

MR. SIMON: Absolutely correct. The proportions are such now that action can wait no longer.

MR. PETERSON: Thank you, Bill Simon, very much.

We have someone else, it is to be hoped, on the phone, Doug Dillon. He has an excuse for not being here that is at least as good as Bill Simon's. He is on his honeymoon. He is so committed to this effort that he has indicated he could say a few words. Doug?

PRESENTATION OF C. DOUGLAS DILLON, FORMER SECRETARY OF THE TREASURY, 1961-1965 (BY TELEPHONE)

MR. DILLON: Yes, here I am. You have said it so well and Bill Simon has said it so well that there is not much one can say except to say amen to what you have said.

However, we all agree, I'm sure, all Americans agree that our primary job now is to get the nation moving again on a steady course of growth and it certainly cannot be done unless we handle this deficit problem. I would like to say one little thing about our tax system, and I know Joe Fowler is going to speak further about it, and that is with our dependence on the income tax system, which is very heavy, heavier than any other country, and with the indexing provision that goes into effect in 1985, we have literally put ourselves in the impossible situation of unless we can find another source of revenues, then the consumption area is the area that we must aim at.

The reason for that is that after we have all the reductions that we have been talking about and that we find necessary, there still will, most likely, be a modicum, a certain amount of inflation, and it's hard to realize how important even a small amount is. If the inflation is reduced 4 percent a year -- we hope it will be lower than that -- but even at that, in 10 years, the course would go up more than 50 percent, and if our receipts are being held level, as I think they should be, by indexing, we certainly have to find a different and comparable source of income to make up for that difference.

The only basic funding of it is in some form of increased taxation, and it should be consumption levels to keep incentives available for our nation's economy to get back to work.

I think that is about all I have to say, and thank you very much.

MR. PETERSON: Thank you, Doug, and we all wish you a happy, happy honeymoon.

Mike Blumenthal, Secretary of the Treasury in the Carter Administration, is an aged expert in many areas. He has recently been looking at the global economy, the developing countries, the fragility of the financial system, and, in addition, anything else he wants to talk about. Perhaps, Mike, you could talk about the international aspects of this crisis.

PRESENTATION OF W. MICHAEL BLUMENTHAL, SECRETARY OF TREASURY, 1977-1979

MR. BLUMENTHAL: Thank you, Pete.

I will be very brief also. I merely wish to reiterate and expand briefly on the point that Mr. Peterson made in relating our economic problems in this budget situation to the global picture. We all know that at the present time, our own economic difficulties are mirrored by similar slowdowns in other developed countries in Europe, even in Japan. And, in particular, we know that the developing countries, including some with whom we have very close relations, are, at present time, in great difficulty. They cannot meet their foreign debts. Their growth rate now is less than their population rate. They cannot pursue these development programs that have been underway for some years, and without that, the difficulties are very severe, and the prospect of political instability in these parts of the world is very great.

It is easier, therefore, that the United States economy and our budget problems are part of a larger picture, and as you study that you see that very, very clearly, and you come clearly to the conclusion that unless we solve our problems, it is very difficult to see that the rest of the world can get back on a track of steady and sustained growth.

At the same time, our own relationship to these areas is so great that unless they do, we, in turn, cannot hope to solve our situation at home.

The reason for that is very simple: High, continuing deficits in the United States mean continuing high interest rates, as Mr. Peterson has shown, and high interest rates mean an overvalue of the dollar. We have seen that in the recent past that a greatly overvalued dollar undermines the international trade picture and creates protectionism worldwide. It undermines and destroys our competitiveness in world markets.

At the present time, we are looking in 1983 at an unprecedented trade deficit of -- it is estimated somewhere in the range of $80 billion or more. That is truly an unprecedented number.

$80 billion or more involves a reduction of the GNP growth by about a percent and a half or more. If you will recall that we are estimating a growth now of about 1.4 percent, I think is the number, that really means that because of that trade deficit, we are cutting our expected growth in 1983 in half.

It means that we are sucking in a lot of imports because of the overvaluation of the dollar. It means that our exports are substantially reduced. That means one to two million jobs in the United States lost as a result of this kind of situation.

So we have a very direct domestic interest in seeing to it that our budget situation is brought under control so that the high interest rates and, therefore, the overvalue of the dollar situation, can be corrected.

Finally, I merely wanted to add that it hurts us indirectly, as well. Because as I have said, this kind of situation has created the most serious problems for the developing countries.

We know the problem in Mexico and Brazil, in Argentina. There is a long list of countries who are presently struggling with the implications of this worldwide situation.

All of the major banks of the world, not only the U.S. banks, are involved with loans in these countries. The stability of the banking system depends on correcting that situation.

If these countries cannot pay their debts, they have to scale back on imports. They don't have the capacity to import, and in this way, we are, again, very much affected because these developing countries are the single largest, in totality, the single largest export market for the United States.

It is not realized that that is really larger than the markets in Europe where the developed countries are located.

U.S. trade, as a percentage of our GNP, has doubled over the last 10 or 15 years. One in six people are manufacturing works for export now. Two out of five acres of farm land are dedicated towards the export markets. I think you can see how that interrelationship, in a global context, is a very , very close one and, therefore, our ability to assure the world that we are making the changes that put the budget picture, structurally, on a sound basis in the years to come, really is a key for the kind of global recovery, and that that is very much in our own self interest.

Thank you, very much.

MR. PETERSON: Secretary Joe Fowler, let's see, Joe, I believe it was the Kennedy and Johnson administration.

PRESENTATION OF HENRY H. FOWLER, SECRETARY OF THE TREASURY, 1965-1968

MR. FOWLER: Under Secretary Dillon and Kennedy and Secretary for Johnson.

MR. PETERSON: You are qualified to speak as a card carrying democrat, I take it?

MR. FOWLER: Exactly. Unreconstructed.

I would like to make three comments: First, one, I would like to get that last chart about taxes up here.

First, in the interest of accuracy, this committee, parts of its inspiration is to bring accuracy to the process of understanding the budget. Therefore being always suspicious of charts, I am kind of hipped on the question of accuracy. I have a personal reason for making this point.

In the first chart that you had in your packet there showing the range of deficits, it would appear that the last surplus we had in the budget was in 1950.

Now, that is so far back you might say, "Well, why worry? This is all something in the past. We never had a surplus in the budget in our life time."

The chart is incorrect. If you will look at the President's economic report, for example, in the 1980 report, pages 284 to 286, you will see that we had a surplus in the budget, well, the fiscal year beginning July 1, 1968, to June 30, 1969, of $3.236 billion; not a very large surplus, but large in those days.

So this can be done, and many of you will not recall it, but some of you will: It took a lot of blood, sweat and tears to correct the tax setup at that particular time by increasing taxes in an election year and sharply reducing the projected expenditures for that particular year which changed a $25 billion deficit the fiscal year before to a surplus for that fiscal year.

So this is something that can be done if you get a bi-partisan will to do it.

And a bi-partisan aspect of this program is the second point I just want to allude to. In order for our program to be believed, it cannot be -- or any corrective program to be believed by the business community over a sufficient period of time change the psychology and attitudes and to go in for investment and for increasing productivity through new and more efficient plant and equipment, and all increasing capacity anticipating a health growth in the economy, you have got to have a program that will be believed and a program that is purely partisan will not be believed.

A program that is bi-partisan has some chance of being sustained and is what is necessary to do the job.

Now, both Mr. Peterson and Doug Dillon have made references to the taxes. I just want to point out that proposing an additional $60 billion of tax revenues for the year 1985, fiscal year 1985, does not increase the percentages of GNP that are currently the case in 1980, 1981 and 1982.

It really just levels out at a 20.2 percent of the GNP level. So we are talking about not through this $60 billion, pushing up beyond what we have been used to the range of revenues in a percentage relationship to GNP.

We are stabilizing at about that particular level.

Now, the most important aspect that I want to mention is one that Mr. Peterson has referred to: The stipulation in our program and in our advertisement that this increase in taxes of $60 billion to help bring this budget backwards, in the moving south, in the direction of equilibrium by 1985, the principal source of these increases must be from consumption based taxes and some minor elements from user fees on governmental commercially available services.

Now, that means that the $60 billion of increased revenues should not come from any surtax on the corporate or personal income taxes or any increase in rates on personal and corporate income taxes or any major tampering with the present pattern of existing credits or deductions that would diminish the income paid by corporations or individuals.

It does mean that the $60 billion of increased revenues would come from excise taxes on particular items or commodities or products or services or sales taxes covering a broad spectrum of our sales of goods and services or, perhaps, a more attractive option, an installation or the beginnings of the installation of a value-added tax which would be comparable to that generally employed by our trading partners and our trading competitors in Western Europe.

You will find, on examination -- and Mr. Peterson has referred to this -- that the United States, compared with four of its principal competitors, Japan, West Germany, France, and the United Kingdom, extracts the greatest share of revenue from taxes on income on investment and property and the smallest share from taxes on consumption and payrolls.

You will also find that U.S. public revenues received from taxes on investment, capital gains, property, business and corporate earnings presently exceeds, as a share of GNP, that of any of these other nations and in some cases, by a very, very substantial degree.

Now, is this just a technical difference that we are talking about here of how you squeeze a goose or how you extract taxes from the body politic? No, it is much more than a technical difference. It is a very substantive policy difference, which is very important to our competitiveness here at home and to our increase in productivity here at home and to our gaining our rightful position in the export markets abroad.

Mr. Blumenthal has referred to this, to our ability to grow, to increase jobs and increase the general standard of living for our people. It is that important a difference. It should not surprise us that as a result of the difference in our tax system, from those of the nations I have mentioned, our levels of household savings and business capital formation and investment are, as a share of GNP, the lowest and, in some cases, by far the lowest of any of the countries mentioned.

In reaching out for increased revenues for our tax system for the fiscal year 1985 in the amount indicated, we must use that to help close the gap in the budget deficit. It does provide us an additional dividend, in a sense, by giving us an opportunity to make a significant shift in the direction of our tax system in moving, the way it is moving, by imposing these taxes on consumption and carefully avoiding any of the deadening effect that would come from increased taxation that would affect savings and investment.

We can begin to reverse a tax policy that favors consumption at the expense of savings, and we can begin to more closely adapt our tax system to that of our principal trading friends and competitors and thereby put ourselves into a position to realize our proper share, not only of growth here at home, but of growth in the world markets which is so important, becomes so important a part of our future health and prosperity.

Thank you very much.

MR. PETERSON: Thank you, Joe.

I would just bring this to a close in the following way. I had forgotten who the Frenchman was who once indicated that when economics gets important enough, it becomes political. We may appear innocent, naive, ignorant of the political realities of the program we suggest. One of the reasons that we are part of this program, as I indicated at the outset, is that we realized that past Administrations have been an important part of the problem. I think we also realize that political leaders will not adopt this program unless they feel that it is politically realistic.

The political landscape that must change profoundly in America is one that I told a commentator about this morning, if I saw Steinberg doing a painting of a political map of America from Washington in the same way that he did of New York, where you may recall there were the Empire State buildings and the skyscrapers, and then the Hudson River and then way out there a ways were some minor mountains and deserts and then a tiny little pond that was the Pacific Ocean, but it was the New Yorker's preoccupation with his vision of the world. I would guess that a political map of America would probably see an America made up of recipient groups, of military pensioners who, after five years or so, are getting substantially more than they did full-time; of Federal pensioners and staff workers who are in the same position, of various recipient groups; of entitlement programs for the elderly, of people looking for subsidies and special interests and so forth. I have argued that we cannot blame our political representatives if they represent us.

Until, somehow, the American people start getting the message, we have what I think is probably a new version of the silent majority, that is silent and uninformed and unorganized and not very passionate compared to the recipient who treats this society as though citizenship consists of being on the other end of a vending machine and seeing how much you can get. Thus, I don't think that we can simply or fairly blame our political leaders.

So I think our effort going from this day forward is to do what little we can, and we are under no illusions of the immense difficulty of what we propose: to see if Americans of both parties can start expressing their deep concern tangibly to their representatives for the future of this economy and society.

I want to thank our supporters, again, for coming. We will be glad to take a few questions. I am sorry if we have exhausted you, but we will be glad to take any questions that you have.

QUESTION: Mr. Peterson, you talk about a commitment to the poor, but consumption taxes tend to hit the poor more than middle classes and well-to-do people. How do you reconcile that?

MR. PETERSON: Which tax?

QUESTION: Consumption taxes.

MR. CONNALLY: Let me take that one. It doesn't have to. It doesn't have to at all. You can have a value added tax for consumption for a family member that would alleviate that problem completely. It depends on how you structure it.

MR. PETERSON: As we have indicated, on the indexed programs, there are half a dozen ways that you could protect those with the lowest wage history. All that is required is a commitment to do it, and we have that commitment.

Yes, sir?

QUESTION: A year ago you were at the National Press Club, and you were saying essentially the same things that you have said today except at that time you were worried that the deficits would go into triple digits. You were worried about $100 billion. Today you are looking at deficit projections that are two or three times that much. What are you going to do this time around?

MR. PETERSON: You mean if you wait a year, it will be $400 billion? I want to get the thrust of your question.

QUESTION: I am just wondering what will you do this time around to more effectively sell your view to the Administration and the Congress. Are you getting discouraged?

MR. PETERSON: I don't have our previous statement here. I should. My impression was that our 1985 deficit reduction goal was, even then, $175 billion and that our estimates are proven to be more accurate than we may have wished. As a matter of fact, in spite of the action that was taken this summer, the deficits have gone up so much that we are stuck with the same target that we had then.

There has been some progress since then in one respect or at least two respects. You recall that, if you were here, the first principle -- and you gentlemen will recall this -- was fiscal realism. Do you remember? That was the number one principle. We were arguing that the deficit projections that we were hearing of $92 billion heading downward $57 billion, or whatever they were, were unrealistic. They were going to be much higher than that.

I think the one place there's a bi-partisan consensus today in and out of government is on the magnitude of the deficit problem. If you believe that you must first define a problem before you can solve it, which we do, we believe this is real progress.

The other thing we have seen since our May announcement is that we have been able to attract about 500 leading Americans; 50 cabinet officers from both parties; about 50 heads of universities and highly distinguished professors of economics from left to right, 14 out of the 15 chief executives of Wall Street's top 15 firms. We have the heads of most of the large law firms; most of the large accounting firms and perhaps 300 or more chief executives of basic and important American companies who have not been often willing to speak out with a common voice.

We are going to try to broaden this coalition to include the young. We don't have a chance here to go into the crucial implications of the Social Security and entitlements problem to the young. I would argue -- and I've argued with my own children -- who are preoccupied, as yours probably are, with getting ahead, and whichever friend they're going to be with or living with or whatever the construct is . . . laughter . . .

MR. PETERSON: responds -- That they have got to be deeply concerned about the implication of paying for taxes those 7 trillion dollars worth of unfunded liabilities. The young have only begun to understand these implications. We are now beginning to talk to youth organizations. We want to talk to farm organizations; housing organizations; minority organizations; all kinds of organizations to broaden this effort.

Don't let me sound arrogant on the behalf of any of us. We know that this problem is immensely difficult. However, I was taught at the University of Chicago that if you didn't have an alternative, you didn't have a problem. It has been a very sobering thought ever since. What is the alternative? Is the alternative to face something that nearly all of us -- all of us -- agree threatens the very future of our society and our economy? The alternative is to try. That is all we are doing. We are not asking for anything. We're trying to fight this malignant tendency in America to conclude that the sum of a bunch of special interests somehow adds up to the general interest. What we are saying, alas, is that this is not so. If it may not be too presumptious, I hope we generally represent the general interest. I don't know of anyone here that is running for office. I guess with this program, I'm not sure how we would do . . . laughter . . .

MR. PETERSON: Yes.

QUESTION: How many women do you have amongst those 500?

MR. PETERSON: Not enough is the answer. We have, in the Cabinet area, Carla Hills is a member, Lucy Benson is a member. Shirley Hofstedler just joined our group. Matina Horner from Radcliffe; Jill Conway from Smith; Donna Shalala of Hunter College; I have also persuaded my wife, Joan Ganz Cooney, President of the Children's Television Workshop, to join this effort. We don't have enough women. We have the National Women's Political Caucus that I believe has joined us. You can appreciate that to get organizational support for a program of this sort is a fairly lengthy process. It requires deliberation; going through the process, and so forth. The answer is we do not have enough women, but we are going to try to get a lot more.

QUESTION: Sir, in your estimation what is the expected revenue costs through fiscal year '86 of President Reagan's 1981 tax cuts? What I would like to know is how much revenue has the President and Congress written down in the 1981 revisions?

MR. PETERSON: Could we have that chart again on taxes? I think if we look here at the percentage of GNP, which I think is probably the right way to look at it, you can see that.

MR. CONNALLY: 750 billion dollars gross.

MR. PETERSON: A couple of our supporters indicate the number is $650 billion over that period of time, but in the year 1986, do you know Andy Brimmer what it would be?

MR. BRIMMER: That is the cumulative period.

MR. PETERSON: Do you know what it would be in the year 1986? The reason I was looking at the chart is that the share has fallen from something like 20 to 21% of the GNP down to 18.7 so that in terms of GNP there's been a drop of about 2 to 2 1/2% of the gross national product. Is that about right?

MR. BRIMMER: Yes.

MR. PETERSON: But, alas, spending has gone down up about 2 1/2 to 3%, and it is that yawning gap that creates the problem.

QUESTION: Could we extrapolate, then, that had this tax system not been altered two years ago, perhaps some of these problems would not have been quite so severe.

MR. BLUMENTHAL: That would not dissolve the whole problem by any means.

MR. PETERSON: It still would not have solved the problem, because you still would have had a deficit that would have been substantial. These indexed, entitlement programs have been growing for a decade at 15% annually or more.

MR. CONNALLY: You have to remember that they imposed almost $100 billion of new taxes last year.

MR. PETERSON: This was the number I showed in the out year. I'm sure it -- I'm looking at my colleagues here -- includes the tax increases that we had this last year.

Consistent with our program, sir, I think what we would have wished and what we continue to wish is not that the tax cut would have been less, but the spending reduction would have been equal to the level of the cut in revenues so that those resources could have been released to the private sector. That is why we put primary emphasis on the spending programs. Yes?

QUESTION: Assuming you want to raise $60 billion in taxes, can we assume that you want to do away with the July tax cut?

MR. PETERSON: No you cannot assume that at all. The principal thrust we are talking about are consumption based taxes. I also remind you that we are talking about the year 1985. One of the reasons that we are focusing on '85 is that in '83 we are coming out of a serious recession. And reasonable persons of different persuasions could have different views of the precise fix and monetary mix in the midst of a recession. In fact, a reasonable case could be made for accelerating the tax cut if certain other actions were taken on the spending side right along with it. So you cannot make that assumption.

QUESTION: Mr. Fowler, wouldn't a tax on consumption have the effect of discouraging consumption; as a result keep the unemployment problem bad?

MR. FOWLER: I do not think that has been the experience either with sales taxes or value added taxes. I think that the selective excise tax system has something of that flaw in it, and that is one reason that selective excises might be very much of a third choice, because it would single out particular items of particularly a broad scale, an excise tax structure of the sort we had in the late forties and early fifties, which was a relic of a wartime tax policy, but I think a general sales tax or a general value added tax or a consumption tax will perhaps encourage people to save and invest rather than to spend on non-essential areas. That is where you're going to get your increased savings. The other economies that are referred to, if you looked at the figures, you would find that for example in Japan the rate of household or personal savings is around 20-21%, whereas in the United States it characteristically runs 6 1/2%; maybe up to 7 1/2 or down to 5 1/2 but in that general range.

MR. BLUMENTHAL: I would just like to also add that you will recall that I said earlier the trade deficit has cost us 1 to 2 million jobs, or will cost us that this year. To the extent to which through this shift to other kinds of taxes we increase our export competitiveness, which Secretary Fowler said this would do and I would agree, we would be creating or regaining some of these very jobs, so they are very, very important offsets, and you could argue that from an employment point of view, you could be as well or better off.

MR. FOWLER: And you would increase purchasing power by that very token, because the more people that work, the more overall income there is and the more consumption.

QUESTION: Mr. Fowler, what is the percentage point value of a tax you would need to raise roughly $60 billion in '85?

MR. FOWLER: I have not structured that comment because our group as a group has not come to any decision or any conclusion as to a particular consumption tax form we would approach. We are not here advocating anything in particular, only that it be in the consumption area and that $60 billion not be the result of increasing the income tax structure.

MR. PETERSON: Joe, I hope that John Connally wouldn't mind my saying -- maybe I can build a little interest, John -- that you're going to have a press conference, when did you tell me?

MR. CONNALLY: Three o'clock.

MR. PETERSON: At three o'clock to discuss the proposal he has that relates to, as I understand it, value added tax. Perhaps if you can come back here, you can give a summary of your proposal.

MR. CONNALLY: Well, to answer that question specifically, again, it depends on what exemptions you have in it, but it would be obviously, a very very small percentage on a value added tax to produce $60 billion a year. Let's assume you do it when your gross national product is for a trillion dollars, again let's assume no exemptions, no exceptions, no remissions of any kind; just the 2% value added tax would produce $80 billion a year.

QUESTION: Could I ask the opposite of the question from over here? Do these figures and charts assume that the third part of the income tax cut will take effect as scheduled?

MR. PETERSON: Yes Yes.

QUESTION: To what extent has your group discussed these proposals with the leadership in Congress on both sides as well as with the Reagan administration, and what has been their response?

MR. PETERSON: Well, precisely because it is a bi-partisan group; because we don't have anything to hide; because we have education as an important purpose, from the beginning of this program I think my colleagues will reaffirm that every couple of weeks or so we've kept the House leadership of all developing committees; the Senate leadership, the White House, the senior cabinet officers of the United States concerned with economic policy very much informed about what we are doing and why.

I think it would be inappropriate for me to characterize their reaction. It depends on how you define "they." There are many people who speak for various institutions. Privately, we have had many strong words of encouragement. We are going to see Senator Baker, who is one of the three addressees, this afternoon. Speaker O'Neill, I understand, is out of the city, but we have been in close touch with the House and Senate Budget Committee, the Ways and Means and Finance Committees.

Many of them have asked us to testify, and I think part of our deal, and I would hope part of our supporters deal, would be that we would be willing to put our mouths where our words are, and when it comes to speak up on behalf of programs of this sort we will be available to testify.

QUESTION: Do you estimate that these measures on the budget will actually increase growth taken on their own? Do you speak a lot about the dangers to recovery from large budget deficits? I wonder if you all believe that reducing the budget deficits will lead to faster growth?

MR. PETERSON: I'll speak my mind. I certainly do.

MR. CONNALLY: I certainly do. I think the huge deficits endanger interest rate declines. I think if these deficits continue, you're going to see interest rates increase again. How high they will go, no one knows, but nothing has been more detrimental to the economy of this country, in my opinion, than high interest rates and when we talk about taxes and the effect it will have, I don't think it has any measurable effect compared to what high interest rates have done to this country.

QUESTION: And you blame the high interest rates primarily on fiscal rather than monetary policy?

MR. CONNALLY: It is both, but you have the monetary policy because you have the fiscal policy. You have the feds saying that we couldn't stay at the rate of inflation that we are experiencing in this country. They were using the only tools they had, which was high interest and tight money, to bring down the rate of inflation which has been successfully done, but at a very high price and that is a major recession in this country. If we get the deficits under control, the American people and the world, indeed, Secretary Blumenthal said, if the world can believe that we're really coming to grips with fiscal affairs of this country, that I think you'll see a restoration of competence over the long run; you will see interest rates come down, both short and long term and you will see a major change of the expansionary activities in this country.

MR. BLUMENTHAL: I think the long-term interest rates are very critical toward reestablishing confidence and stability and stable growth, and it is in those long-term interest rates Mr. Peterson has referred to that show, in real terms, historically, abnormally high levels. Until these come down, I think most of us feel that the prospect for a sustained recovery are very poor.

MR. PETERSON: I might just take two aspects of that. I was recently at a meeting with Lee Iacocca of the Chrysler Corporation, you needn't have me elaborate on the state of auto industry.

I think in several of these industries there is a clear view of a kind of threshold level of interest beyond which sales volume falls off in very, very large measure. Lee indicated that if he could get interest rates down under 10% he thought that would have a dramatic effect on the auto industry.

MR. CONNALLY: Let me give you a case history on that to prove your point. What was headlines in the Austin American paper last year in Austin, Texas should have been headlines all over America: Two developers, real estate developers there worked out a deal with a California savings loan association and provided interest of 7% in the first year, 9% in the third year, I believe, and 11% thereafter with a 5% downpayment on a house of $70,000.00, which is $3,500.00, and they have made that available to the whole community.

They were absolutely overrun. They were inundated with purchasers. They sold 10 million dollars worth of houses in three days time. They were writing up contracts on a new house every fifteen minutes. That is what lower interest rates will do for you.

MR. PETERSON: And the effects on the dollar, we cannot overemphasize the importance of that. Fred Bergsten is here who is one of the leading experts in the world on this subject. I think you will confirm, Fred, that is your estimate that the dollar is overvalued 20 - 25% on a trade weighted basis?

FRED BERGSTEN: Before it declined.

MR. PETERSON: Yes, before the recent, very recent decline. At least that much vis-a-vis the yen, and that has had a critical effect on our export position. I mentioned Caterpillar. The head of Caterpillar had indicated for example that whereas they used to be the leading -- I believe, Fred, they had the largest trade balance of any company in America -- they are now often finding it almost impossible to compete with their principal Japanese competitor because the exchange rate was at such a level that they could not cover their costs in competing for overseas business.

Mike, you participated in some meetings of the Business Roundtable where the incredible impact of our drop in exports was discussed. You can say anything you wish about that.

MR. BLUMENTHAL: I just merely wish to reiterate the case of Caterpillar, which I have heard, too. The dramatic change and the reduction in exports by the Caterpillar Company is precisely mirrored by the import picture of the Japanese competitor Komatsu. So you will have the yen/dollar relationship showing you almost a mirror image of what happens. It is not because Caterpillar has suddenly become less competitive in other ways. It is the other way around.

MR. FOWLER: Ms. Atkinson, I believe your question went to whether or not the closing of the deficit would be beneficient or perhaps have a destructive impact question on growth.

MR. FOWLER: I would say that we are not lonely in our view, but the lowering of the deficit, the declining deficit would be a beneficient influence.

I would cite, for example, Mr. Delarosiere the Managing Director of the International Monetary Fund, who made a very informative speech within the last few months in which he analyzed the situation of most of the industralized countries of the world who have somewhat similar problems in which he brought out that the deficit problem and the curing of the deficits, putting their economies on a declining scale as far as deficits were concerned was fundamental to the restoration of any pattern of sustaining growth such as was characterized in the fifties and the sixties, and this is kind of item 1 in his analysis of what the developed world needs to do to pull itself out of the recession bordering on world depression that we seem to be sliding into.

MR. PETERSON: Ms Atkinson, I might indicate something you undoubtedly know. Something over a half trillion dollars worth of debt in the Third World with, I believe, the debt service payments of 50 to 75 billion dollars each year, the scenario that concerns many people -- we have some of the world's leading experts here -- is the scenario whereby those debt service payments grow, compounding one on the other, in the context of a world economy that is not growing.

One can easily see that if you have several years of those kinds of debt service payments in the context of global stagnation, debt service payments, then, become, I would say, virtually impossible to handle, with all of its implications on the global financial system. Many people who know more about this business than I do tell me that nothing would stimulate the world economy more than to get our fiscal situation under control.

QUESTION: No one has mentioned the fiscal '84 budget. I wonder whether you thought the sky would be the limit on that deficit and that is one question.

MR. PETERSON: If we were given the impression that the sky should ever be the limit, we have failed miserably.

QUESTION: I would like to get your view on the '84 budget which is right in front of us right now. Also do you think President Reagan shares your apprehension about the dangers of these high deficits, or what makes you think that he does?

MR. PETERSON: I have trouble speaking for myself on some occasions: I will let the President speak for himself. He has certainly, in times past, stated his deep concerns about deficits.

As far as 1984 is concerned we focused on '85 intentionally because we think that is the critical longer term signal that is needed.

We have not worked out a detailed program for 1984. But, it must be clear to everyone that you don't get from 250 billion to 75 billion in one step. You get there by reducing all of these programs, and the longer you wait, the more draconian the cuts need to be in that year. That is why we would like to see a freeze very soon.

QUESTION: Do you have a target number for a deficit in 1984?

MR. PETERSON: No, only 1985. I think we are close to exhausting everyone, aren't we? Thank you, very much.

QUESTION: Can you tell us where and when the ads will run.

MR. PETERSON: The ad will run, forgive the expression, in the Washington Post, and it will be a two page ad. This will be followed by advertisements, schedules, which are as yet undetermined, in other national media. Thank you, very much (whereupon, at 12:23 p.m., the news conference was concluded.)

Committee to Fight Inflation

Fourth Policy Statement

January 12, 1983

Inflation has abated markedly since early 1980. At the same time the rates of unemployment and business failures have increased to postwar record levels. With the price indexes rising less than half as fast as earlier and with unemployment swelling to 10.8 percent of the labor force, it is not surprising that recession has largely supplanted inflation as the economic problem of most immediate concern to the public.

We must recognize, however, that the battle against inflation is far from won.

Inflation also slowed dramatically as a consequence of the 1974–75 recession, but later it accelerated to a new peak and it may well do so again. Even if inflation does not accelerate, the current rate is rapid enough to do enormous further damage to our economy and our society.

Our government should not abandon the fight against inflation now, because of the recession. To do so would mean that the nation had paid heavily in lost output, lost employment, and widespread deprivation for the second time in a decade without winning the only reward—a stable price level—that could justify so great a cost.

The Committee to Fight Inflation, a bipartisan group of citizens who have had major governmental responsibilities in the economic and financial area, has issued three policy statements since June 1980. At the outset of this new statement we note our deep concern about the many forces that are now pressing government policy in mistaken directions.

We are disturbed by the prospect of huge budgetary deficits for the indefinite future. We are disturbed by the apparent inability of our policy makers to come to grips with the fundamental problems of the social security system. We are worried that Congress will enact so-called jobs bills whose stimulative effects will be felt mainly after the recession is over, when they will feed inflation rather than ameliorate recession. We are worried about the possibility that Federal Reserve policy will swing toward economic stimulus, perhaps in response to a congressional mandate to seek lower interest rates. And we are distressed by the apparent receptivity of the Congress to legislative proposals to restrict competition at home and from abroad—proposals that would serve special interests at the expense of the national interest in economic growth and price stability.

These forces that disturb us should also disturb every American who believes that the nation's goal should be a steadily growing, noninflationary economy. In the sections below we briefly describe the kinds of monetary, fiscal, and trade policies that are required for continuing progress toward that goal.

Monetary Policy

The government's main weapon in the fight against inflation has been the monetary policy pursued by the Federal Reserve. Because the rate of growth of money has been reduced on balance since late 1979, the growth rate of dollar GNP (total spending for the purchase of goods and services) has slowed. Because the rate of increase in wages and prices moderated only a little at first, the induced weakness in dollar demand has kept output and employment from rising and has increased unemployment.

Over the past year, however, the increases in labor costs and prices have slowed considerably—although not enough as yet to permit employment to rise. If this process is allowed to continue, the rates of increase in wages and prices will fall enough to permit a lasting recovery of output and employment in a noninflationary environment.

The great risk at present is that monetary restraint will be relaxed to an undesirable degree. We are particularly concerned about the implications of various bills now pending in Congress that would encourage or require the Federal Reserve to aim at reducing and stabilizing interest rates. The pursuit of such interest rate objectives under mandatory direction from sources outside the Federal Reserve is likely to be inflationary. Also, because it would create a resurgence of inflationary expectations in financial markets that would put upward pressure on interest rates, it is certain to be self-defeating.

Fiscal Policy

The federal budget deficit for fiscal 1983 is now estimated at about $190 billion, or more than 5 percent of GNP. If there were no change in current spending programs or tax laws, the deficit would equal

4 or 5 percent of GNP through 1988, and it would remain extraordinarily large for the indefinite future, even after substantial economic recovery.

Large deficits are a normal consequence of recessions, which hold down tax receipts and increase unemployment benefit payments and other outlays. Insofar as deficits are induced by recession, they are not necessarily inflationary. *There is, however, no precedent in our history for a stream of enormous deficits long after the end of a recession.* The prospect of continuing deficits of the order of 4 or 5 percent of GNP is particularly disturbing because such deficits would absorb the great bulk of private saving, which typically runs between 6 and 8 percent of GNP. With so little saving remaining for use by the private sector, real interest rates would stay abnormally high and the investment needed for growth in production and productivity, and for jobs in the private sector, would be retarded indefinitely.

Large deficits in nonrecession years would also have important short- and long-run consequences for inflation. In the short run, their inflationary effects could, in principle, be offset by greater monetary restraint, but that would complicate the problems of the Federal Reserve. Their longer-run inflationary impact would arise out of the frustrations of a citizenry with a tradition of rapidly rising living standards that finds itself condemned to a stagnant or slow-growth world. Under such circumstances there inevitably would be rising pressures for larger slices of the inadequate pie—in such forms as demands for bigger increases in money wages, greater protection against imports, and expanded restraints on domestic competition—all of which would contribute to inflation.

Clearly, we must foster a resumption of substantial and sustained economic growth, and for this purpose we must sharply reduce the size of prospective federal deficits. We recommend that, beginning with the budget for fiscal 1984, the deficit as a percentage of GNP should be scaled down progressively and significantly as the economy moves toward high employment and price level stability. Rather than a constitutional amendment, we recommend enactment in this session of Congress of a law that places a steadily declining limit on deficits for the next five fiscal years. The law should permit deficits in excess of the specified limit only when authorized by legislation approved by three-fifths of each house of Congress and signed by the president.

The needed reductions in the deficit will require extensive and significant action on both the expenditure and the tax sides of the budget. That action should be taken in the current session of Congress.

Any significant expenditure savings will have to come from the areas of federal pension programs, including social security; Medicare; and/or defense. Together with interest charges, these categories will account for almost three-fourths of gross federal outlays by 1985, and programs in the remaining one-fourth have already been subjected to substantial cuts.

Social security and related programs

However difficult politically, it will obviously be necessary to slow the growth of outlays for social security and Medicare, as well as those for civil service and military retirement and for other programs that confer benefits on the middle- and upper-income classes. We recommend progressive cutbacks from currently projected outlays over fiscal years 1984–1988 by some combination of the following measures:

1. Limiting the size of cost-of-living adjustments in social security and other federal retirement benefits.
2. Extending the coverage of social security to federal civilian employees.
3. Subjecting to personal income taxes social security benefits in excess of the beneficiary's previously taxed contribution, as is now done with private pensions.
4. Modifying social security benefit formulas to strengthen incentives for people to defer retirement. At present the incentives are perverse; for example, the benefits for people retiring between ages 62 and 65 are actuarially equivalent to those for people retiring at age 65, whereas benefits for those postponing retirement until after 65 are below the equivalent level. (Changes in these provisions should be implemented over an extended period, in order to avoid imposing on large numbers of people a sudden need to make substantial changes in their plans for retirement.) Also, for people who want to continue working after beginning to receive benefits, the so-called retirement test imposes a heavy effective tax on earnings above a relatively low level, discouraging their participation in the labor force. The retirement test should be abolished at the same time that benefits are subjected to income taxes.

As to financing the social security program, we would not favor drawing on general revenues to make up any shortfalls; social security benefits should be funded wholly out of social security taxes.

In the national debate that has been precipitated by the financial problems of social security, the fundamental issue is the choice that must be made between slowing the rise in benefit payments to retirees and increasing the volume of tax receipts. This issue is being debated on various bases, including those of inter-generational equity and longer-run economic growth, and the ultimate decision may well involve changes in both benefits and taxes from those provided by current law. We wish, however, to stress another major factor bearing on this choice: *Any increase in social security taxes raises business labor costs, and thereby contributes directly to the inflation that our nation is now struggling to eliminate.*

Defense outlays

The size of the defense budget has come under increasing scrutiny. *In our view, defense should not be judged as a budget issue.* The economy of the United States is so large and strong that expenditures far greater than proposed can be handled if they are truly necessary. We are not competent to judge the substantive merits of defense issues, although we are impressed by the wide differences of view among competent judges.

We recommend that the Congress, with the assistance of the administration and the advice of other qualified people, undertake a fundamental reappraisal of the defense program. Such a review may result in identifying currently planned expenditures that could be progressively eliminated or scaled back over fiscal years 1984–88 without damage to the national security.

Other taxes

In order to avoid weakening incentives to work, save, and invest, we would not favor reversing the changes enacted in 1981 in corporation depreciation allowances or the reductions made then in individual income tax rates and in estate and gift taxes. We would, however, urge consideration of certain tax measures to become effective at times consistent with the proposed targets for reductions in the deficit. These measures include temporary new taxes on energy consumption, temporary increases in excise taxes on alcohol and tobacco, and the imposition of additional user fees for commercially valuable government services. If more revenue is needed, consideration might also be given to a broad-based consumption tax.

Barriers to Competition

As noted earlier, monetary restraint acts by slowing the growth in total spending. To the extent that wages and prices continue to advance, the spending slowdown means cutbacks in output and increases in unemployment.

The fight against inflation is proving costly in lost output and employment because it is necessary to overcome the considerable momentum built up by the wage-price spiral over the 1970s. Among the reasons that wages and prices have been resistant to the induced weakness in demand are (1) the widespread doubts that progress against inflation will continue and will prove durable, and (2) the weakness of competition in many markets. The two great solvents of wage and price resistance to monetary restraint are credibility of the anti-inflation effort and market competition; any government measures that increase either will make it possible to overcome inflation sooner and at less cost.

Unhappily, the trend appears to be toward government actions that weaken competition, in the process casting doubt on the government's determination to fight inflation. The strong effort of recent years to scale back anticompetitive domestic regulations appears to have stalled. Congress has been disturbingly receptive to bills that would extend new protections against domestic competition, including measures to relieve doctors and other professionals from the surveillance of the antitrust division of the FTC and to give beer distributors and office equipment retailers immunity, like that granted earlier to soft-drink distributors, from antitrust scrutiny of exclusive territorial arrangements. And, most ominously, pressures are mounting rapidly to provide new protections against imports through domestic content legislation and other devices.

Anticompetitive measures of these kinds are deplorable under any circumstances, because they are an inefficient means of conferring benefits on particular groups and because the claims of those groups to special benefits are often dubious. But their extension at a time when the nation is engaged in a costly struggle to overcome inflation is nothing short of tragic. *Protectionist measures are particularly tragic because they provide no benefits at all; any jobs saved in industries competing with imports are at the expense of jobs lost in export industries.*

Fundamentally, inflation will slow only to the extent that people have incentives to moderate their wage and price demands. Because anticompetitive measures weaken such incentives they undercut the struggle against inflation and magnify its costs.

The Committee to Fight Inflation is a bipartisan group of former government officials and members of Congress with extensive experience in the economic and financial area who have joined together to promote effective anti-inflation policies. The American Enterprise Institute for Public Policy Research provides certain support services to the CFI but has no role in its substantive work; the CFI is solely responsible for its findings and recommendations. The committee was formed in 1980 and its first chairman was Arthur F. Burns, who is now U.S. ambassador to West Germany.

The Committee to Fight Inflation

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HERBERT STEIN
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Copies of this statement are available from:

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March 23, 1983

The Honorable William C. Clark
Assistant to the President for
National Security Affairs
The White House
Washington, D.C. 20500

Dear Judge Clark:

Last month you wrote to the founding members and supporters of the Bipartisan Appeal on the Budget Crisis. You urged us to reconsider our advocacy of a more gradual and durable buildup in defense spending than the one the Administration is proposing. Since then, your comments have been distributed to the press.

We have reviewed your letter in detail and conclude that in significant respects it misconstrues the program we have endorsed. Moreover, we believe that your comments may obscure important issues underlying the current debate over defense spending and give the entirely false impression that we are less than resolute in our commitment to protecting this country's national security. The purpose of this letter is to clarify our program and objectives and to respond to your contentions.

At the outset, we should point out that each one of us shares the Administration's overall perception of the need for a steady, determined and substantial strenghtening of our defense capabilities. As former public officials, we share your grave concern with the Soviet military expansion in the last decade and the threat it poses to this country, our allies, and free people the world over. As citizens who have been involved in international affairs, we deplore the relative decline in our own defense capability during the 1970's.

Three of our founding members were co-founders of the Committee on Present Danger, and all of us have devoted a great deal of time and thought to our defense needs and how to finance them. Thus, when you talk of the need to reverse past trends and ensure a strong defense capability, you tell us nothing that we do not already know, and indeed nothing that we have not ourselves said for many years. And when you talk of the Soviet threat you raise no specter that we do not already recognize.

Our disagreement, then, is one of approach and pace. We believe that military strength must go hand in hand with enduring economic strength, that global influence and security are impossible without steady economic expansion. Moreover, we are convinced that neither military nor economic strength is sustainable except in a time of major war if the federal budget runs structural deficits in the range of 5% to 6% or more of GNP. Those deficits would abort economic recovery and render any steady expansion in our defense capability politically unlikely.

As Dr. Martin Feldstein, Chairman of the President's Council of Economic Advisors, has pointed out, a high and steady rate of economic growth cannot be assured unless real long-term interest rates are brought down to reasonable levels, and those rates cannot be brought down to such levels unless the structural budget deficit is drastically reduced — cut to less than 2% of GNP.

This is precisely our goal, and we believe it should be achieved by fiscal 1985. In numerical terms, this means that something in excess of $175 billion must be trimmed from the out year deficits. Our proposal is to accomplish this through significant reductions in fiscal 1985 nondefense spending, more modest reductions in fiscal 1985 defense spending and increases in revenues. The alternative to a balanced and politically acceptable program of this sort is economic stagnation, insufficient capital investment, high unemployment, declining world influence and, ultimately, a reduction in the real resources available for our national security. (As to unemployment, we do not accept the implication in your letter that — in the face of unprecedented high deficits and prospective soaring interest rates — increased defense budgets will increase total employment.)

We believe that the deficit must be reduced in a way that does not jeopardize the national security; and we also believe that if the deficit is not reduced it will jeopardize the national security. Accordingly, we would respond to the Soviet buildup and our own relative decline in defense capability not by merely selecting a numerically impressive figure for defense spending growth (or defense spending as a share of GNP), but rather by asking what defense capability we need, what missions our military units should be able to perform, what situations and specific threat projections we should be ready to meet, and what technologies and hardware we need to develop and procure to meet them. Our previous levels of defense spending or the levels maintained by other nations — including the Soviets — provide neither clear answers to these questions nor a rationale for failing to ask them this. Soviet spending may affect the threat we face. But it does not tell us how much to spend to counter that threat. Nor does the projected size of the out year deficit provide an answer; if we truly need to spend more than we can afford with current revenues, those revenues can and must be expanded.

Our experience in public life has taught us that there is nothing more costly, both economically and politically, than a defense buildup punctuated by starts and stops — ill conceived surges forward and abrupt reversals. We would send a far stronger signal to our allies and adversaries alike if we were to select a sustained and sustainable defense buildup which is affordable and politically supportable over the long term. Such a buildup would be militarily more effective and diplomatically more impressive than the fitful course to which we fear the current defense program will be consigned by projected budget deficits.

In short, while we firmly believe this nation can afford whatever national security capabilities it truly needs, we know it cannot afford defense expenditures it does not need.

THE ECONOMY AND OUR PROGRAM

Before outlining facets of the current defense program which seem inadequately justified, it is necessary to address a number of your contentions regarding our current economic situation and the program we have proposed for coping with it.

First, your letter asserts that the proposed defense budget "is not the source of the deficit problem." To support this contention, you note simply that as a percent of total federal spending or GNP the Administration's defense program will cost less than the defense programs of the 1950's and 1960's. Unfortunately, nostalgic comparisons with earlier periods are not necessarily relevant. Not only was our fiscal situation more balanced in those years, but our economy was performing far better than it is now — national productivity was growing rapidly and we faced no serious international competition in our basic industries. Thus, while the past may be prologue, it tells us nothing about our current fiscal and economic plight. The present facts, in contrast, speak rather forcefully, as the following table illustrates:

	(in % of GNP)		
	FY 1981	FY 1985	CHANGE
Federal Revenues	20.9%	19.0%	-1.9%
Total Outlays	22.9%	24.1%	+1.2%
Defense Outlays	5.1%	7.0%	+1.9%
Deficit	2.0%	5.1%	+3.1%

To put it bluntly, the growth in defense spending between fiscal 1981 and fiscal 1985 more than accounts in percentage terms for the growth in federal outlays in that period and is a major contributor to the massive deficit projected for fiscal 1985.

Second, your letter seeks to deflect attention from the defense budget to the historical expansion in social programs. We certainly share your concern with nondefense spending — historically it clearly has been the major contributor to our current fiscal plight — and we support the Administration's efforts to focus attention on this problem. Indeed our proposals are for more permanent reform and far greater cuts in nondefense spending than any the Administration or the Congress has been willing to consider. For example, our program calls for fundamental changes in the indexing of government entitlement programs as well as a one-year freeze on cost of living adjustments. Also, the Bipartisan Appeal calls for a $60 billion reduction in fiscal 1985 nondefense spending (excluding interest). The Administration calls for a reduction of only $36 billion. We would also make the obvious political point: significant and indispensable cuts in nondefense spending are far more likely to be negotiated if real defense budget reductions are part of the overall budget package.

Third, your letter implies that we have suggested there is some inequity or unfairness in the Administration's defense budget. If you look more closely at the program in our advertisement, we are confident you will recognize that we questioned not the fairness of the defense budget, but rather the equity of the decision to cut means-tested entitlements — those that help the very poor — two times as much as non-means-tested entitlements — those which confer a substantial portion of their benefits on middle and upper income groups.

Fourth, your letter asserts that we favor nondefense programs which we would "like to" fund over defense programs which the nation "must" fund. We reject the suggestion that our proposal favors whim over necessity and the notion that every expenditure for defense is automatically sacrosanct. We do not question that this nation should do what it "must do." Rather we question, as every citizen should in a time of severe fiscal strain, any uncritical adherence to a prescription which does not adequately analyze and define what is meant by need. There is no reason to believe that "throwing money" at defense in the 1980's will achieve more satisfactory results than throwing money at social problems in the 1960's.

Fifth, your letter suggests that the Administration has already cut its defense proposals as much as possible by paring away some $66 billion in previously proposed expenditures. In fact, the Administration originally proposed increasing real defense outlays in the period from 1981 through 1985 at a compound annual rate of an unprecedented 10.4%. The most recent Administration proposal still envisions that this rate will be about 10% — from $146.0 billion in 1981 to $213.4 billion in 1985, in 1981 dollars, (or 16.4%, from $146.0 billion to $267.9 billion in nominal dollars). In its initial program of March 1981 the Administration called for fiscal 1985 defense outlays of 6.45 percent of GNP and it now calls for fiscal 1985 defense outlays of 7.04 percent of GNP. Indeed, in constant 1981 dollars the Administration's current proposal for fiscal 1985 defense outlays is only $3.9 billion below the proposal it put forward in March of 1981.

Sixth, you assert that any cuts in fiscal 1985 defense outlays would stall multi-year programs, disrupt complex development and deployment schedules and force the cancellation of ongoing contracts. However, new or incipient programs can clearly be eliminated without disruptions. Moreover, the cancellation of unnecessary programs will save, not consume precious resources -- probably resources considerably in excess of those currently estimated in light of the propensity of new programs to cost far more than initially projected.

THE DEFENSE BUDGET ITSELF

Let us now turn directly to a number of somewhat more specific issues raised by the Administration's defense budget.

Our starting point, as noted above, is that a realistic defense program can only be developed by relating specific expenditures to specific strategic goals and missions. Any other approach will inevitably obscure the central question, which is what defense capabilities are truly necessary to support a military strategy accepted by the President and Congress alike.

At the outset, we applaud the current Administration's efforts in a number of areas. The first is combat readiness, which, as your letter points out, has been significantly improved. Combat readiness clearly relates directly to tangible military goals, and the Administration's achievements in this area have our firm support. Similarly, we applaud the Administration's early efforts to ensure that our uniformed service personnel are fairly paid, and we would oppose efforts to reduce funds for salaries, housing and training of such personnel. Indeed, we wonder whether a freeze on military pay is an appropriate step at this time. Our defense capability clearly depends to a significant degree on our fighting men and women.

We also support the Administration's commitment to basic technology and research and development in the defense area. This, too, relates directly to evident strategic goals and does not seem a candidate for substantial reduction. Finally, we commend the Administration for its efforts to improve procurement practices and ensure that defense dollars are spent efficiently. We are confident that important new initiatives in these areas will emerge when the President's Private Sector Survey of Defense Department operations (the Peter Grace Commission) makes its recommendations. Indeed, we understand that this Commission, which surveyed Defense Department operations from July through December of 1982 with four different task forces made up of some 150 volunteers, will recommend a large number of specific opportunities for substantial defense savings.

We do wonder, however, whether the connection between proposed programs and an appropriate military posture is well documented in other important areas. We recognize, of course, that none of us is expert in the field of strategic planning or military procurement and that we lack access to classified information. We have however consulted many such experts, some of whom have participated in formulating defense policy at senior levels, and we are impressed by the broad consensus among these experts that sizable portions of large programs have not to date been adequately justified in terms of clear and realistic defense goals and missions.

For illustrative purposes, we have, in consultation with these experts, identified three broad categories in which the relationship between proposed expenditures and viable strategic goals has yet to be demonstrated. We feel that at a time of grave fiscal stress the Administration has a duty to demonstate that relationship, and that if it is unable to do so, appropriate reductions in the rate of growth of defense spending must be given serious consideration. The categories and some of their constituent elements are sketched below.

1. Marginal or Questionable Military Missions. This category consists of instances in which experts have questioned whether particular strategic goals are in fact feasible or realistic. Where the goals or missions advanced to support specific programs are not justifiable, the programs are often allowed to survive not by force of logic, but rather by dint of rhetoric. Some of the major questions are:

(a) Whether "horizontal escalation" has been used to justify substantial expenditures. We understand that the Administration early announced the strategy of "horizontal escalation," which apparently denotes the capability of initiating military action in one geographic area in response to Soviet aggression in another. Unless clearly limited, this concept appears capable of justifying a defense establishment with the ability to fight simultaneously in every corner of the globe. Yet surely no one would seriously advocate such a goal. As a result, we, like the defense experts with whom we have talked, question whether horizontal escalation can serve as a useful guide to budget formulation. To date, however, it is not clear how much of the Administration's projected outlays for increased procurement of conventional military equipment, transportation capability, etc. is required to restrengthen America and how much reflects initial enthusiasm for the questionable doctrine of open-ended horizonatal escalation.

(b) Whether sea-based air attacks on Soviet ports and mainland is a realistic mission. The Administration has proposed providing the Navy with three new nuclear carrier task forces (carriers and supporting ships) so that "high threat areas" — that is in areas near or on the Soviet mainland can be attacked from nearby carrier based platforms. The experts with whom we have consulted have questioned whether this is a sensible strategic mission both because Soviet air cover would make it costly for these carriers to approach within range and because other methods of countering the Soviet naval threat may prove more effective. The total price of these new carriers and support systems could be in the $50 billion range in 1983 dollars, and we wonder whether an expenditure of this magnitude does not require more persuasive justification.

(c) Whether the desire to "prevail" in a nuclear war motivates substantial expenditures. The Administration initially articulated its defense proposals in part with a view towards waging and prevailing in a protracted nuclear war. We understand that some of the Administration's rhetoric may have been misunderstood, and that such language is not now a part of official doctrine. We also understand, and agree, that our traditional policy of nuclear deterrence requires substantial flexibility. Yet despite recent changes in official terminology, it is unclear to what extent the idea of a protracted nuclear war continues to motivate significant portions of the Administration's proposed outlays for civil defense; command, control, communications and intelligence systems; new strategic weapons and new delivery systems; a new continental air defense system, and increased research on ballistic missile defense. In our view, either the mission itself must be justified by some more coherent policy explanation — and many defense experts doubt that this is possible — or the Administration must demonstrate the extent to which these outlays can be otherwise justified.

2. Unnecessary Duplication and Redundancy. We are advised that we may be in danger of procuring overlapping or duplicate weapon systems to serve some missions or strategic goals that are themselves clear and persuasive. Those with whom we have consulted doubt that such duplication is truly necessary. Some of their questions are:

(a) Whether a panoply of overlapping strategic bomber forces is necessary. We do not question the need for a strong and modern strategic bomber force. We do wonder, however, whether compelling arguments have yet been advanced in favor of simultaneously improving the B-52 H penetrating bomber, procuring the B-1 penetrating bomber, developing a Stealth penetrating bomber, and buying air-launched cruise missiles, especially at a time when many other new strategic systems are being proposed. Before we spend the large sums required for this arsenal, there should be a clear demonstration that what appears redundant is in fact a strategic imperative.

(b) Whether there is a danger of unnecessary redundancy in procurement for the tactical air mission, including close air support. The mission here is manifest — the need to provide effective tactical fighters for a variety of purposes, including interdiction, air cover, ground attack and others. Yet numerous experts have questioned whether we need, in the name of close air support, to proceed simultaneously with the AH-64 helicopter and the AV8-8B vertical takeoff aircraft, particularly after having purchased more that 700 A10 fixed wing aircraft. These same experts have questioned whether we need the

F14, the F18, the F15, and the F16 for fighter and attack missions. The tactical air mission has been the most costly of our several defense programs, and the burden of proving necessity is on those who favor such vast and potentially duplicate procurement.

3. Expenditures with Ill-Defined Purposes. Thus far, we have considered strategic missions that, to a number of experts, appear dubious, as well as potentially unnecessary duplication in procurement for manifestly valid missions. Here we consider whether a number of proposed expenditures are adequately linked to strategic goals in light of a variety of diplomatic, practical and logistical concerns. Some of the questions are:

(a) Whether there has been optimum coordination with our allies. Some experts have suggested that we have not coordinated strategic planning with our allies in a way which maximizes efficiency and equitably distributes the burdens. Programs are now underway, for example, for US non-nuclear forces to acquire munition stocks sufficient for at least 90 days of combat. Our European allies, who would fight alongside us, in contrast, have stocks for at most 30 to 45 days. We wonder whether this discrepancy calls into question some of our proposed expenditures for increase munitions stocks.

(b) Whether proposed increases in manpower are persuasively linked to specific goals. The Administration has proposed increasing military personnel by ten percent or about 200,000 men and women. Yet it is not clear whether these increases support specific strategic goals. Nor is it clear whether we can transport and sustain additional Army forces with our present sea and airlift capabilities. Finally, many have questioned whether any increases in manpower that are in fact justifiable could more economically be accomplished by strengthening the reserves or the National Guard.

(c) Whether all existing military bases are necessary. There has long been a consensus that the Armed Services maintain facilities in this country substantially in excess of those required by purely military objectives. Whether such facilities and bases survive by force of inertia or through Congressional pressure, they appear strong candidates for reevaluation. We believe that the President should convene a panel of former military officials and knowledgeable civilians to evaluate current domestic facilities and determine which are necessary and which can be scaled back or eliminated without jeopardizing our national defense.

We recognize that the foregoing comments and questions are conceptual rather than specific. They are also only illustrative. Other practices and policies in the Defense Department may also support our view that strengthening America can be more affordable. Our effort here, however, is not to write a new defense budget or to make definitive judgments about specific weapons systems. That is the province of the Administration in consultation with the Congress; and we would not be so presumptuous as to suggest that we can or should displace that process. Rather we want to suggest that our proposal for a modest reduction (approximately 7%) in the Administration's fiscal 1985 defense budget is far from unreasonable. Indeed, our program calls for a compound real rate of growth in defense spending of 8% during the period from 1981 to 1985. The House Budget Committee, in contrast, has proposed growth at the significantly lower rate of 6.8%, and the Administration budget calls for a growth rate of about 10%. Before such an unprecedented growth rate can be justified, we believe, the Administration must systematically relate major programs and expenditures to essential goals and missions. Until this has been done, it is simply not possible to make a persuasive argument that every dollar of the proposed budget is necessary to our survival as a nation.

More broadly, it is important to recognize that short-term military spending does not lead ineluctably to long-term military strength. Indeed, in the present fiscal climate excessive short-term military spending can actually be harmful by undermining the political consensus required for a sustained defense buildup and smothering economic growth beneath huge outyear budget deficits.

The ultimate goal of a strong defense posture is to support a strong foreign policy. But history teaches that no nation can long maintain a strong foreign policy without a strong economy. One need only look at countries whose economies have declined to see how rapidly they have turned inward, become absorbed with protectionist measures, and faded as major forces on the world scene. To support the economic growth we need, there is no alternative but to reduce the out year deficits, and that can only be done by cutting defense and nondefense spending alike. The link between the two is political as well as economic. It is unlikely that the major reductions in nondefense spending that are required will be politically supportable unless they are accompanied by at least some reduction in defense spending. If the Administration overlooks this connection, it will run the substantial risk that its defense budget will founder in a hostile Congress.

Military strength, our confidence in it, and our national will to acquire it, depend not just on how much we spend for defense but also on how shrewdly and steadily we invest those dollars. Strength in the decades to come, in short, can best be achieved by marshalling behind the President continuing bipartisan support for a steady, coherent and believable defense buildup -- one that is justified by reasoning and foresight and financed by long-term prosperity.

In this spirit we would strongly urge the President and the Congressional leadership to join together in supporting a bipartisan resolution committing the nation to a significant and sustained increase in the defense budget for the next several years. We believe such a bipartisan commitment would give confidence to our allies and make the President a more powerful negotiator on this country's behalf.

As we said in the letter of January 10, 1983 to the President, Speaker O'Neil and Senator Baker: "The signal we should be sending to the world is that Congress is united behind the President in a program to rebuild our military strength. A message of disharmony would detract dangerously from the credibility of our entire defense effort, and, indeed, of the President, as Commander in Chief."

We do not believe that the proper signal can be sent if the Administration remains wedded to the levels of deficit financing called for in the current budget. Politically, that deficit financing will undermine the bipartisan support the President needs. Diplomatically, it will send allies and adversaries alike the message that this nation is not determined to stay the course. And economically, it will jeopardize the recovery. In consequence, if the Administration's assessment of our defense needs is correct, it has no alternative but to raise revenues — beyond the levels we propose -- to pay for its program.

In closing, we urge the Administration to scrutinize its proposed defense budget as rigorously as possible. At stake is our very future as a politically united, economically prosperous and militarily powerful nation.

President Eisenhower once remarked:

> "The threat to our security is continuing and many-sided. We must be able to demonstrate a good case as to the austerity of our operations. Otherwise cuts will be forced on us. If we reach too high, we might attain our goal for one year but then be cut back. There is, so far as we can determine, no single critical danger date. True security for our country must be founded on a strong and expanding economy."

We hope this Administration will take these comments to heart. They are as powerful today as they were a quarter of a century ago.

Respectfully submitted,

W. Michael Blumenthal

Henry H. Fowler

John B. Connally

Peter G. Peterson

C. Douglas Dillon

William E. Simon

Place on 23rd

RECEIVED
MAR - 9 1983

THE WHITE HOUSE
WASHINGTON

February 25, 1983

Dear Mr. Blumenthal:

You recently endorsed an advertisement presenting a "Bipartisan Appeal on the Budget Crisis" which received broad publication. We believe it would be helpful if you were aware of several factors pertinent to the President's multi-year program to rebuild U.S. national security capabilities:

First, there is a basic reason for the President's defense program. This Administration inherited a national security posture that had experienced a dollar decline after inflation in eight of ten years in the 1970s. As a percentage of the total budget and of the GNP, defense spending had fallen to its lowest level in 30 years. This chronic underfunding of defense had serious adverse effect on our military readiness. Military units were underequipped to perform their missions. There was a huge backlog of deferred modernization and maintenance. We had failed to integrate critical technology into our weapons and defensive systems. Military morale was low, as was the quality of life of our uniformed personnel. America was more vulnerable. Meanwhile, Soviet military capability had increased dramatically. By the end of the previous Administration there was a belated appreciation of these problems. Corrective actions had commenced. President Reagan arrived in office with a mandate to rebuild our national security capabilities. His defense program was and is designed to do that, so that we may be able to defend successfully our country and our Allies, and otherwise to protect our global interests.

This brings us to the question of the size and pace of the President's defense program. His objective is to develop, within a given time frame, a specific defense capability to counter specific threat projections. This force development must, of course, be managed within the context of the President's Program for Economic Recovery. But, if we are to rebuild U.S. defenses in a timely and orderly manner, improvements cannot be continually deferred as a technique for reducing the deficit. Nor should they be. The proposed defense budget is not the source of the deficit problem. As a percentage of either total Federal spending or the GNP, the cost of our current defense program is less than that devoted to defense in the 1950s and the 1960s. It is proportionately large only when compared to underfunding in the decade of the 1970s. The increase in defense spending is proportionately small when compared to the increase in domestic spending.

Next, we must ask ourselves if there is equity in the President's proposed budget. I question the logic of the appeal you endorsed. It is suggested that, in the interest of fairness, we should not do what we consider necessary to ensure our national security. To say that because we cannot do all we would like to do for domestic programs, we should not do what the President feels we must do for defense is, in my view, a dangerous method of setting priorities -- much like the philosophy resulting in the decline in our national security in the last decade. In recognition of economic constraints, the President's original multi-year defense budget has already been modified substantially. As a result of our and of Congressional action during the past two years, the President's proposed $116 billion increase over outlays planned by the Carter Administration has been reduced by $66 billion, a 57 percent decrease. The Department of Defense has thus far been able to maintain priority modernization programs; but it will not be able to sustain these programs if we subject defense spending to yet another round of cuts.

Let us examine implications of a defense reduction of the order you suggested. We could more easily discuss the contention that it is possible to reduce Fiscal Year 85 defense outlays by yet another $25 billion without "gutting our military security," if some attempt had been made in your appeal to specify precisely what reductions could be justified. The proposed reduction appears to have been arrived at by looking to a hoped-for result rather than by an analysis of the defense program. It ignores the fact that we are in the middle of multi-year programs with two successive years of increased readiness and modernization funding already under way. To suddenly abandon these programs would seriously disrupt our steady effort to rearm America, and would revive the discredited and dangerous pattern of deferring needed modernization. Outlay reductions of the level suggested by your group could require cancellation of many major strategic and conventional weapon modernization programs. The gains of the last two years would be lost as would the resources already invested. Let's also be realistic: contract cancellation and deferral costs would be severe, and the impact on employment in the defense industry would be substantial.

While the defense budget is an easy target when viewed by budget cutters in terms of billions of dollars, it is another matter when viewed not in dollars but rather in resources for maintaining specific programs, such as our first line of defense as required by alliance commitments, ensuring United States access to vital regions of the world, establishing a basis for real arms reduction talks, or maintaining a stable global environment within which democracy and western economic systems can flourish. Elimination or significant reduction of resources in support of any one of these goals would encourage the Soviets and bolster their capability to deny us all of such goals.

I urge that you reconsider your group's suggestion that there is $25 billion of nonessential spending in the defense program and that the President's effort to rebuild America's defenses can be harmlessly deferred. We are today forced to grapple with the consequences of yesterday's deferral and underfunding of our defense program. Commitment and resolve are essential if we are to avoid that problem tomorrow and to maintain our national security.

It is obvious that you have a serious and legitimate interest in the national security of our country. We both know that reasonable people can differ on basic defense policy. I hope you now have a better understanding of our aims, perhaps to such a degree that you might modify your support for a reduction in our national security program. The President and I welcome your personal views, and I encourage you to communicate directly with me.

Enclosed, for further background, is a detailed fact sheet on our defense program.

Sincerely,

William P. Clark

Enclosure

FACTS AND FIGURES ABOUT THE REAGAN ADMINISTRATION DEFENSE PROGRAM

The Soviet Program

- Total Soviet investment in future military capabilities -- that is, production of weapons and other equipment, construction of military facilities, and research and development -- was nearly double ours by the early 1980s.

- Broken into component parts, Soviet investment in strategic nuclear forces was about three times higher than ours; investment in general purpose forces was about 50% higher, and investment in research and development was about twice our rate.

- Even with President Reagan's increases to the defense budget, we still fall far short of offsetting Soviet production of weapons. For example, the FY 1984 budget provides for 720 tanks while the Soviets' average annual production for their own forces is over 1,900 tanks. We are requesting funds for 190 artillery and rocket launchers; the Soviets' annual production is over seven times greater. In addition, they produce on the average twice as many combat aircraft and three times more warships than President Reagan has requested in his budget.

- The Soviets have also extended the reach of their military power. They have: acquired security and cooperative agreements worldwide; undertaken massive arms deliveries to Third World Countries -- double the amount we supplied from 1977-1981; acquired Cuban, East German and Libyan military proxies in Central America and Africa; greatly increased their power projection capabilities; expanded their overflight and access rights to operating bases in key parts of the world; and occupied Afghanistan.

The Defense Program: Accomplishments

- The all-volunteer force made a dramatic turnaround in 1981, and was even more successful in 1982. Last year all three Sevices met and exceeded their recruiting quotas for the first time since 1976, and the percentage of recruits with high school diplomas was 86% last year (FY 82) up 18 percentage points from 1980.

- Military readiness improved substantially. The number of active units that are fully or substantially combat ready has increased by 32% since January 1981.

- Increases in the operating tempo of our forces -- more flying hours for pilots and field exercises for our units -- have provided invaluable additional training. For example, Air Force tactical crews now fly an average of about 18 hours per month -- nearly a 50% increase over the FY 1978 low of 13 hours.

- Increased funding for supplies and ammunition -- 30% above the Carter level in FY 1982, 50% above in FY 1983 -- have increased the number of days of munitions supply by 10%. When the materiel funded by the FY 1984 budget is delivered, we will have increased our ability to sustain combat by another 25% over the level we inherited. This helps ensure that no adversaries ever calculate they can outlast us.

Defense and the Economy

- Even with our planned increases, defense spending will be only 7.7% of the GNP by 1988 (end of FY'84 FYDP), compared to the 8-9% which was typical during the 1950's and 1960's. (Year by year breakdown: 6.5% in 1983; 6.8% in 1984; 7.3% in 1985; 7.6% in 1986; 7.7% in 1987; and 7.7% in 1988.)

- Over the past two decades the growth in Federal spending has not been in defense, but in transfer payments, which grew 337% between 1962 and 1982 in real terms. During this same period, defense spending increased by 5%.

- In fact, during the 1970s, defense spending fell almost 20% in real terms, while federal transfer payments grew by 122%.

- It is interesting to note that in 1969, when defense outlays were high due to the Vietnam War -- about 43% of Federal spending -- the Federal budget was in surplus. In fact, 1969, was the last year of a budget surplus. In contrast, real defense outlays in FY 1983 will be less than they were in 1969 -- only about 27% of Federal spending. Yet we anticipate a significant budget deficit.

- At a time when less than 70% of America's manufacturing capacity is being used and unemployment exceeds 10% of the labor force, defense investments are important to a stronger GNP.

ECONOMICS

TUESDAY, FEBRUARY 15, 1983

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met at 10:14 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Boschwitz, Grassley, Gorton, Chiles, Biden, Metzenbaum, Riegle, and Exon.

Staff present: Stephen Bell, staff director; Gail Fosler, chief economist; Richard N. Brandon, minority staff director; and Kemble Stokes, chief economist for the minority.

Senator BOSCHWITZ [presiding]. We welcome you this morning, Dr. Rivlin, and I see that the Chairman, Senator Domenici, who is late, has a prepared statement and inasmuch as it is rather short and inasmuch as it makes some points that he wants to make for this hearing, I will, with your permission, read it.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Dr. Rivlin, as always, it is a pleasure to welcome you to this committee. As you are aware, Dr. Rivlin, this committee expects to proceed on an accelerated schedule this year. We hope markup of the First Budget Resolution for fiscal year 1984 begins on March 7 and with floor action completed hopefully by the Easter recess. This is an ambitious schedule which we hope to keep.

FEDERAL DEFICIT MUST BE REDUCED

This committee will face many grave and, I freely admit, unpleasant choices when it begins to develop a budget. The Federal deficit, particularly the years beyond fiscal 1984, must be reduced and by large amounts.

Prior to 1981, when the Congress enacted the President's fiscal program, one of the largest single sets of budget actions in recent memory was the social security legislation of 1977 which amounted to almost $90 billion in both spending and tax changes. The last Congress enacted about $900 billion of tax and spending changes, including planned higher spending for defense. This extraordinary amount may still not be adequate if we look at certain measures of the problem we face.

The CBO annual report projects deficits, rising from $194 billion in fiscal year 1983 to $267 billion in fiscal year 1988. It will take tough decisions to reduce these deficits. We must be prudent. We must be fair. We must be deliberate. We cannot be arbitrary.

It is for this reason, Dr. Rivlin, that I hope you will provide us with some direction as to the specific deficit goals that this Committee should reasonably set for itself. On the one hand, we must reduce the deficits as much as we can. On the other hand, we do not want to reduce the deficits by so much so rapidly that we cause economic disruption by our own actions.

Therefore, I hope that you will provide us guidelines for specific deficit goals. Are the President's goals sufficient? Should this committee go beyond the President in reducing the deficit? Some of your standards for reducing the deficit would suggest that we should.

The question of structural deficit reduction is made all the more difficult because we are compelled to take these stringent actions at a time of high unemployment. The decisions of this committee will have to achieve the delicate balance between the stabilization needs of a weak economy now, and the investment needs of a growing economy later on. To my mind, this requires more fine-tuned judgment than the economic profession has to offer, but I hope you will guide us as best you can.

ECONOMISTS BECOMING MORE OPTIMISTIC

One final point, Dr. Rivlin. I note that as the economic news gets better, economists are becoming more optimistic. I have here, for example, forecasts from Al Sommers of the Conference Board, and from David Levine of Sanford Bernstein, Inc., a Wall Street investment firm. These forecasts suggest that economic growth this year might be one-half to 1 full percentage point higher than the CBO projects, with relatively high growth rates continuing beyond 1983. Is this the beginning of a trend, Dr. Rivlin? Have we been too pessimistic for too long? What are the chances that the economy might recover more strongly than the CBO forecast now anticipates? While I think that we have to guard against excessive optimism, I also think that we do the economy a disservice if we are too bleak in our view. I look forward to your comments on these and other matters.

I join the chairman in these comments and questions.

Senator Chiles, do you wish to make an opening statement?

OPENING STATEMENT OF SENATOR CHILES

Senator CHILES. Thank you, Mr. Chairman.

Alice, I think your most recent report highlights the deficit problem when it notes the "long-term mismatch between Federal spending and taxing." I think it underscores the deficit problem when it says "the American economy faces unprecedented risks in the years ahead unless the Federal Government takes steps to narrow the gap between tax revenues and spending." That is certainly a realistic view.

I do not think that we can look at the size of the Federal deficit without concluding that a large part of it is coming from big spending. Neither can we look at the size of our annual deficits without concluding that a large part of the problem comes from big and permanent tax cuts.

MORE REALISTIC REVENUES NEEDED

Your study tells us that we have to consider all parts of the budget and the tax base, and I certainly concede that the President has put taxes on the table. But it looks like to me that he is willing to let them sit there until fiscal 1986, while the deficits just keep piling up.

Several of us have said that we need more realistic revenues; the President says we need a standby. And to those of us who say that we have got to cancel indexing or modify the third year of the tax cut, the President seems to say sit down.

The White House argues that we need the third year of the tax cut because it is a stimulus to the economy. I think there are two things wrong with that argument. First, I do not know whether we have been able to determine if the first two tax cuts actually served as stimulus. But the third and most important thing is that the stimulative impact is not the real question we are facing here because we are not talking about a 1-year stimulus. We are talking about putting into effect the third part of a 25-percent tax cut which goes on forever, and we will lose that revenue forever. And so the question is, and I think this is the crucial point, not the short term, but the long term, and not the immediate stimulus, but the fundamental structure of the budget.

You again make the following observation in your report:

> Though Federal taxes as a percentage of GNP during the 1984-1988 period are projected to decline to the levels that prevailed in the sixties and seventies; Federal expenditures during the same period are projected to reach more than 24 percent of GNP if no additional spending reductions are made, the budget deficits that would result, 5 to 6 percent of GNP, would be the highest since World War II.

STRUCTURAL DEFICIT

The President often speaks of a structural deficit, and he says that it comes from domestic spending. But I think if we look more closely at that, we see that that kind of deficit means that even with employment levels high, we are still going to be spending more than we take in. Where he says that it comes from domestic spending, if we look at medicare, social security, the means-tested programs, they all now will decline, as in this budget. But defense spending, of course, is going up and revenues are going down. And so the President is insisting upon a revenue policy that is fundamentally altered and permanently reduced, that is unfixed both from realistic defense and domestic spending needs. That is what is giving us the structural deficit, and it is not going to go away unless we make some more sensible adjustment to the revenue policy.

TAX CHANGES AND REALISTIC DEFENSE SPENDING EVIDENT

I do not think there is any way that we are going to get a balanced budget with just spending cuts. There is no way to get a balanced budget just by tax policy or just by restraining defense spending but we have to do something in each of those areas. We have taken the growth out of domestic spending. It is relatively flat now as a percent of GNP, and I think the case for some tax changes is pretty clear, as is the case for a more realistic growth rate in our defense spending.

I certainly support the need for further defense spending but I think it has to be a rate lower than the President plans. I do not think we are going to make much progress on this budget if the White House comes in to this committee with $83 billion in defense spending increases over the next 5 years and tries to convince us it is really a $55 billion cut. We have to be realistic about all parts of the budget, domestic spending, defense spending and taxes, and I think if we can, then we have a possibility to do something.

DEFENSE SPENDING INCREASES OVER THE BASELINE

Senator **Metzenbaum**. Would the minority member yield for a question?

I notice you mentioned $83 billion in defense spending increases over the next 5 years. The figure I have heard was $545 billion for the next 5 years. Are we talking about a different kind of figure?

Senator **Chiles**. I am talking about increases over the baseline.

Senator **Metzenbaum**. Increases over the baseline?

Senator **Chiles**. Right. I keep going back to this little argument that we went through after all the hearings, when everyone went down to the White House and there was a big announcement that the President was going to cut defense spending. And what I keep pointing out is, from last year, they have not actually cut defense spending, they have increased it. They have increased it over 5 years to $83 billion more than what we had agreed to last year and what they had agreed to last year.

Senator **Metzenbaum**. The baseline you are talking about then really is the baseline that was the consensus position of the members of the majority party, and the administration has agreed on after the members of the majority party had refused to go forward with the budget.

Senator **Chiles**. That is right. And what was actually passed into law last year.

Senator **Metzenbaum**. Yes. I just want to be certain that there was not any misunderstanding; that there was really a much greater increase than the $83 billion.

Senator **Chiles**. Yes, sir.

Senator **Metzenbaum**. I appreciate the clarification.

Senator **Boschwitz**. I have a statement from Senator Sasser who is unable to be here that I would like to insert in the record at this time.

Statement of Senator Sasser

Dr. Rivlin, I would first of all like to commend you and your staff for the thoroughness of the recent CBO report to this committee analyzing the economy and the budget. Although I must admit that I found your thoroughness to be most disconcerting.

As we embark on crafting a budget for fiscal year 1984, the size and scope of the problems confronting our economy are truly enoromous. The legacy of the failed Reagan economic experiment is going to haunt this economy for some time to come. No clearer evidence of this can be found than in the President's own budget document.

CRAFT BUDGET ADDRESSING CRUCIAL SOCIAL DISLOCATIONS

The time for a mid-course correction from these policies has long since come and gone. The dilemma that we on this committee now face is to somehow craft a budget that at one and the same time addresses the crucial social dislocations brought on by the current recession and promotes economic growth. Further, this must be done in a fair and equitable manner. The President's budget does not even come close.

While it would be easy to assess blame for the economic malaise we now find ourselves in, the more important task is to develop a prudent and sensible program which addresses the problems confronting the American people, particularly those who have found themselves manning the unemployment lines.

PROJECTED LEVELS OF BUDGET DEFICITS

The projected levels of Federal budget deficits is nothing short of a national disgrace and seriously threaten prospects for even a modest economic recovery. Small business bankruptcies and bank failures are at the highest levels since the Great Depression. Real interest rates remain at historically high levels.

Under the CBO projections, budget deficits continue to increase through the 5-year projection period. In a year in which Reaganomics was to have produced a budget surplus, we are actually facing the largest budget deficit in the history of the Republic, nearly three times the level reached by the Ford administration in fiscal year 1976. The budget deficits envisioned in your projections are not only large in numerical terms but as a percentage of gross national product they are unprecedented. Under the low growth alternative projections, the fiscal year 1988 deficit of $363 billion would represent more than 8 percent of GNP, more than double the previous high of 4 percent.

DOUBLE DIGIT UNEMPLOYMENT

Every bit as startling is the tacit acceptance in these budget projections of double-digit unemployment. In one projection unemployment remains above 10 percent through fiscal year 1985 and at the end of the 5-year projection period is still 9 percent. Even given a modest recovery, unemployment is expected to be close to 10 percent through fiscal year 1984.

While the administration talks of sacrifice, this is truly the cruelest sacrifice that an individual can be asked to make. The time for corrective action is now and it is my hope that we members on this committee can work to alleviate these gross disparities in an effective and just manner. Relaying on the President's budget, however, will only tend to continue the ill-fated path we have been on the last 2 years.

Senator BOSCHWITZ. Dr. Rivlin.

STATEMENT OF ALICE M. RIVLIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Dr. RIVLIN. Thank you, Mr. Chairman. I am very pleased to be here, and I think the thoughtful opening statements of the chairman and of Senator Chiles are examples of the difficulty of the problem that faces you.

My testimony today will focus on several points—the near-term prospects for economic recovery, the uncertainty about how sustainable that recovery will be, and the magnitude and implications of the budget deficits projected under the CBO baseline. I will close with a brief overview of the difficult task at hand and of the administration's proposal for dealing with it. The Congressional Budget Office [CBO] has just issued its annual report—again this year, in three volumes;[1] I will give you a boxed set at a reduced rate—with a great deal of analysis in all of these areas. I am proud of these reports and I hope that they will be useful to the committee.

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[1] See Congressional Budget Office, report to the Senate and House Committees on the Budget as required by Public Law 93-344, "The Outlook for Economic Recovery (Part 1)," "Baseline Budget Projections for Fiscal Years 1984-1988 (Part II)," and "Reducing the Deficit: Spending and Revenue Options (Part III)" February 1983.

THE CBO BASELINE ECONOMIC FORECAST AND PROJECTION

The recession in the U.S. economy, which was initiated by high inflation and tight credit conditions, is now the most severe of the post-World War II period. At the same time, though, the inflation picture has improved markedly; the record slack in the U.S. economy, together with a depressed world economy, have sharply reduced inflationary pressures.

A year ago, CBO projected a recovery during 1982 which did not materialize because of very high interest rates in the first half of the year. Beginning last July, however, interest rates fell in response to the weakness of the economy, declining inflationary expectations, and an easing of monetary policy.

Senator **Chiles**. I hate to interrupt you. You left out one little factor, new revenue was entered into the picture.

Dr. **Rivlin**. I think that may have helped.

As a result, CBO and other forecasters are again predicting a recovery; indeed, there now seems to be fairly broad-based evidence of an upturn in the months ahead. The inventory decline appears to be slowing; auto production is rising; a sharp rise in housing starts portends a pickup in residential construction; and consumers' balance sheets suggest that they are in a position to increase spending.

Senator **Metzenbaum**. Mr. Chairman, I am not sure, as Mrs. Rivlin goes on, can we further interrupt her as she rolls along or let her read her entire statement?

Senator **Boschwitz**. Go right ahead, Senator, since we have only—unless Dr. Rivlin, if you do not object—we have only three of us here and I think we can be more informal.

BUSINESS INVESTMENT IS NOT EXPECTED TO PICK UP

Senator **Metzenbaum**. You make a very strong statement that business investment is not expected to pick up for some time. But my President said yesterday that business investment is picking up very greatly and has done so by reason of the reduction of capital gain tax and a reduction of taxes across the board for the corporate sector.

Now, I happen to agree with you but I wonder if you would clarify why either he is so wrong or you are so wrong because you both cannot be right.

Dr. **Rivlin**. I did not hear the President's statement.

Senator **Metzenbaum**. It was in the Washington Post. I did not hear it either.

Dr. **Rivlin**. It may be a question of time periods.

As we look at the future, it is certainly true that the tax climate is very favorable to investment. On the other hand, the actual plans that businesses are telling the Department of Commerce and other surveyors they have reflected continued weakness in investment plans this year. That is not very surprising. Capacity utilization is at a very low level. Nobody in his right mind builds a new factory when the one that he has got is not fully utilized or even close to it. And as I pointed out, real interest rates are still high by historical standards, although they have come down a lot.

Senator METZENBAUM. From your records, the information available to you, is there any indication that business investment has increased since the passage of the 1981 tax act?

Dr. RIVLIN. No; it has not.

We have had a recession during this period. As is normal in recessions, investment falls off, and it has in this one. It held up fairly well for a while, but for the last period and for the next few months, the investment levels are low.

Senator METZENBAUM. I thank you.

Thank you, Mr. Chairman.

BORROWING BY BUSINESS FOR INVENTORIES

Senator BOSCHWITZ. Dr. Rivlin, pursuing Senator Metzenbaum's question, have you seen any revival of borrowing by business for inventories or noncapital type expenditures? Has that come back at all? I notice that you say that there is at least a decline in the inventory decline.

Dr. RIVLIN. Well, I think that is basically the picture, although it is hard to tell what businesses borrow for. But the inventory accumulation has been worked down to more tolerable levels than it was. That is what normally happens as the recession is turning around.

Senator BOSCHWITZ. Have you noted any increases in borrowing for inventory, the noncapital type of expenditure?

Dr. RIVLIN. I do not know. I will have to answer that question for the record. I do not know that the statistics come that way.

[The following was subsequently supplied for the record:]

Although data on commercial paper and business loans at banks often reflect movements in inventories, the data do not appear in sufficient detail to isolate the financing of inventories from general demands for credit. The latest available data on commercial paper and commercial and industrial loans (December 1982), which continued to show declines in the demand for business credit, undoubtedly reflect the severe inventory liquidation of the fourth quarter.

Senator BOSCHWITZ. Fine.

I find in our State that the demand for funds still seems to be quite low.

Dr. RIVLIN. To continue, Mr. Chairman, the other sign of weakness besides the investment picture is that exports are expected to remain weak both because of the high value of the dollar and because of continued recession abroad. So there are strong points and weak points.

THE CBO SHORT-RUN FORECAST

The CBO short-run forecast reflects the following policy assumptions:

The tax and spending policies are those that were in effect at the end of the 97th Congress. Defense spending is at a level for fiscal year 1984 that is consistent with the budget resolution for fiscal year 1983.

With regard to monetary policy, the broad money aggregate, M_2, is assumed to grow at a 9 percent annual rate during 1983 and

1984. If velocity growth deviates sharply from historical average growth rates—as it did during 1982—however, CBO assumes that the Federal Reserve will adjust its money targets in an attempt to insure moderate growth in nominal GNP.

The short-run forecast also assumes no food or fuel price shocks.[1] However, an assumed 10 to 15 percent decline in the trade-weighted value of the dollar is expected to exert some pressure on prices by raising the costs of imported goods.

The CBO short-run baseline economic forecast (shown in table 1) shows real growth in the gross national product [GNP] of 4 percent from the end of 1982 to the end of 1983, and 4.7 percent in the following year. The unemployment rate is expected to decline gradually, reaching 9.4 percent by the final quarter of 1984. Inflation, as measured by the GNP deflator, deviates little from last year's 4.6 percent (fourth quarter to fourth quarter). Short-term interest rates, as measured by the 3-month Treasury bill rate, are projected to average 6.8 percent in calendar year 1983, rising slightly as the recovery proceeds to 7.4 percent in calendar year 1984.

TABLE 1.—THE CBO SHORT-RUN FORECAST

Economic variable	Calendar years		
	1981 to 1982 actual	1982 to 1983 forecast	1983 to 1984 forecast
Nominal GNP (percent change)	3.3	8.9	9.6
Real GNP (percent change)	−1.2	4.0	4.7
Inflation (percent change in GNP implicit price deflator)	4.6	4.7	4.6
Unemployment rate[1] (calendar year average)	9.7	10.6	9.8
Interest rates (3-month Treasury bill rate, calendar year average)	10.6	6.8	7.4

[1] Excludes uniformed military personnel.

For the years after 1984, CBO projections are not a forecast but merely assumptions about attainable average growth and price behavior. Because of the uncertainty in the economic outlook, CBO has prepared projections according to two alternative economics paths, both of which can be compared to the baseline projection (see table 2). Under the baseline, real GNP is assumed to grow at an annual rate of 3.6 percent, with unemployment declining slowly to 7.5 percent by 1988. Inflation is assumed to decline very gradually to 3.7 percent by 1988. Both short- and long-term interest rates are assumed to drift down slowly in the outyears, though at a somewhat faster pace than the decline in inflation.

TABLE 2.—CBO BASELINE AND ALTERNATIVE PROJECTIONS, CALENDAR YEARS 1983–88

Economic variable	1983	1984	1985	1986	1987	1988
	CBO baseline projections					
GNP (percent change)	6.8	9.6	9.0	8.1	7.6	7.4
Real GNP (percent change)	2.1	4.7	4.1	3.7	3.5	3.5
CPI–U (percent change)	4.5	5.0	4.7	4.1	3.9	3.7
Unemployment rate[1] (percent)	10.6	9.8	9.0	8.4	8.0	7.5

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[1] Food prices are expected to rise moderately during the next 2 years, by 4 percent this year and 5 percent next year. World oil prices are assumed not to change through 1984.

TABLE 2.—CBO BASELINE AND ALTERNATIVE PROJECTIONS, CALENDAR YEARS 1983–88—Continued

Economic variable	1983	1984	1985	1986	1987	1988
3-month treasury bill rate (percent)	6.8	7.4	7.2	6.6	6.1	5.9
	Alternative projections					
GNP (percent change):						
High-growth path	9.0	11.3	9.5	9.1	8.9	9.1
Low-growth path	5.4	7.9	7.9	7.2	6.6	6.4
Real GNP (percent change):						
High-growth path	4.0	6.0	4.2	4.0	4.0	4.0
Low-growth path	0.8	3.3	3.3	3.2	3.0	3.0
CPI–U (percent change):						
High-growth path	4.6	5.3	5.0	4.6	4.6	4.8
Low-growth path	4.5	4.9	4.4	3.8	3.4	3.2
Unemployment rate [1]:						
High-growth path	9.9	8.5	7.7	7.0	6.4	6.0
Low-growth path	11.2	10.9	10.3	9.8	9.4	9.0
3-month treasury bill rate (percent):						
High-growth path	4.4	5.4	5.7	5.0	5.0	4.9
Low-growth path	8.4	9.9	8.9	7.7	7.2	6.3

[1] Excludes uniformed military personnel.

The high-growth path shows a "normal" cyclical recovery, (related to the question asked by the Chairman in his opening statement), with more than 5-percent growth during the first 3 years and 4 percent thereafter. The low-growth path shows a very weak recovery, with unemployment rates averaging about 10 percent over the 1983-1988 period, but with inflation declining more rapidly.

The CBO baseline and administration economic assumptions for the fiscal year 1984 budget show the same basic patterns. CBO's projection (shown in table 3) is somewhat the more optimistic about real growth and inflation during the next 2 years. I think this is the first time that we have been more optimistic than the administration. After 1984, though, the administration sees slightly faster growth, a steeper decline in unemployment, and higher inflation.

TABLE 3.—COMPARISON OF CBO AND ADMINISTRATION ECONOMIC ASSUMPTIONS

	Calendar years								
	1982	1983	1984	1985	1986	1987	1988	1982 to 1983 forecast	1983 to 1984 forecast
Real GNP (percent change):									
CBO	−1.8	2.1	4.7	4.1	3.7	3.5	3.5	4.0	4.7
Administration	−1.8	1.4	3.9	4.0	4.0	4.0	4.0	3.1	4.0
GNP deflator (percent change):									
CBO	6.0	4.6	4.7	4.7	4.3	3.9	3.8	4.7	4.7
Administration	6.0	5.2	5.2	4.9	4.6	4.5	4.4	5.6	5.0
CPI–W (percent change):									
CBO	6.0	3.8	4.6	4.4	4.1	3.9	3.7	3.8	4.5
Administration	6.0	4.9	4.6	4.6	4.6	4.5	4.4	5.0	4.4
Unemployment rate [1] (percent):									
CBO	9.7	10.6	9.8	9.0	8.4	8.0	7.5		
Administration	9.7	10.9	10.0	9.0	8.2	7.4	6.6		
3-month treasury-bill rate (percent):									
CBO	10.6	6.8	7.4	7.2	6.6	6.1	5.9		

TABLE 3.—COMPARISON OF CBO AND ADMINISTRATION ECONOMIC ASSUMPTIONS—Continued

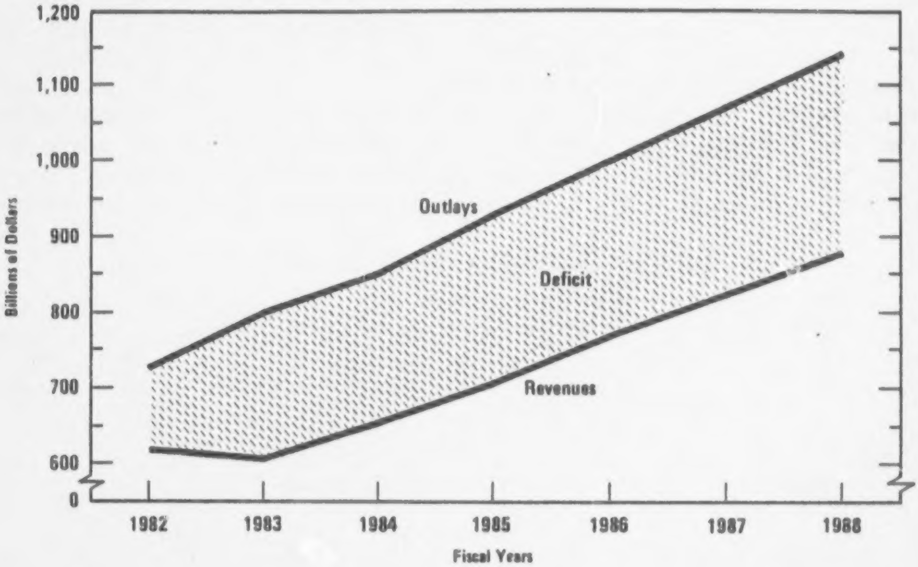
	Calendar years								
	1982	1983	1984	1985	1986	1987	1988	1982 to 1983 forecast	1983 to 1984 forecast
Administration	10.7	8.0	7.9	7.4	6.8	6.5	6.1		

¹ Excludes uniformed military personnel.

THE BUDGET OUTLOOK UNDER CURRENT POLICIES

Although the economy is expected to begin its recovery this year and to move into a period of continued growth, budget projections by both the administration and the CBO show deficits rising steadily under existing tax laws and spending policies. The extremely large deficits CBO projects, which can be seen very graphically in Figure 1—rising from $194 billion in 1983—result primarily from three factors: The current slack in the economy, which reduces revenues in fiscal year 1983; the large tax cuts enacted in 1981 (under the Economic Recovery Tax Act of 1981—ERTA), which reduce revenue growth over the period; and substantial increases in defense, social security, and medicare and medicaid spending, and interest costs.

Figure 1.
CBO Baseline Budget Projections



Federal revenues under current law are projected to be $606 billion in 1983, that is $12 billion below the amount collected in 1982 and $60 billion below the budget resolution target (shown in table 4). This decrease lowers the starting point for the 1984–88 baseline revenue projections.

TABLE 4.—CBO BASELINE BUDGET PROJECTIONS, FISCAL YEARS 1983–88

	1982 actual	1983 base	Projections				
			1984	1985	1986	1987	1988
			In billions of dollars				
Revenues	618	606	653	715	768	822	878
Outlays	728	800	850	929	999	1,972	1,145
Deficit	111	194	197	214	231	250	267
			As a percent of GNP				
Revenues	20.4	19.0	18.7	18.7	18.5	18.4	18.3
Outlays	24.0	25.0	24.3	24.3	24.1	24.0	23.9
Deficit	3.6	6.1	5.6	5.6	5.6	5.6	5.6

Revenues are projected in the baseline to resume their growth as the economy recovers, but the projected growth in revenues is slightly lower than the assumed average growth in nominal GNP. As a result, baseline revenues as a percentage of GNP are projected to be only 18.3 percent in 1988—well below the post-World War II high, reached in 1981, of 20.9 percent of GNP. The main reason for the decline in revenues relative to GNP over the 1984–88 projection period (as shown in table 5) is the large tax reductions enacted in 1981 under ERTA, reductions that were only partly offset by 1982 legislation (the Tax Equity and Fiscal Responsibility Act of 1982—TEFRA).

TABLE 5.—REVENUE EFFECTS OF ERTA AND TEFRA, IN BILLIONS OF DOLLARS AND AS A PERCENT OF GNP, FISCAL YEARS 1983–88

	1983 base	Projections				
		1984	1985	1986	1987	1988
		In billions of dollars				
Economic Recovery Tax Act of 1981	−88	−135	−167	−205	−236	−267
Tax Equity and Fiscal Responsibility Act of 1982	18	38	42	47	54	56
		As a percent of GNP				
Economic Recovery Tax Act of 1981	−2.6	−3.9	−4.4	−5.0	−5.3	−5.6
Tax Equity and Fiscal Responsibility Act of 1982	0.6	1.1	1.1	1.1	1.2	1.2

Federal outlays in 1983, on the basis of actions by the 97th Congress, are now estimated to total $800 billion, a nice round number, or $30 billion higher than projected by last year's budget resolution. Under CBO's baseline assumptions, which include national defense spending levels consistent with the 1983 budget resolution targets, unified budget outlays would decline from 25 percent in 1983—the highest ratio since World War II—to about 24 percent in 1988, a ratio still higher than for all postwar years up to 1982.

More than 90 percent of the $345 billion in outlay growth between fiscal years 1983 and 1988 in the baseline is concentrated in just four areas: national defense, social security, medicare and medicaid, and net interest costs (shown in table 6). These four components will account for 68 percent of total outlays in 1983 and 76 percent of total outlays under CBO's baseline assumptions in 1988.

TABLE 6.—COMPOSITION AND GROWTH OF FEDERAL OUTLAYS

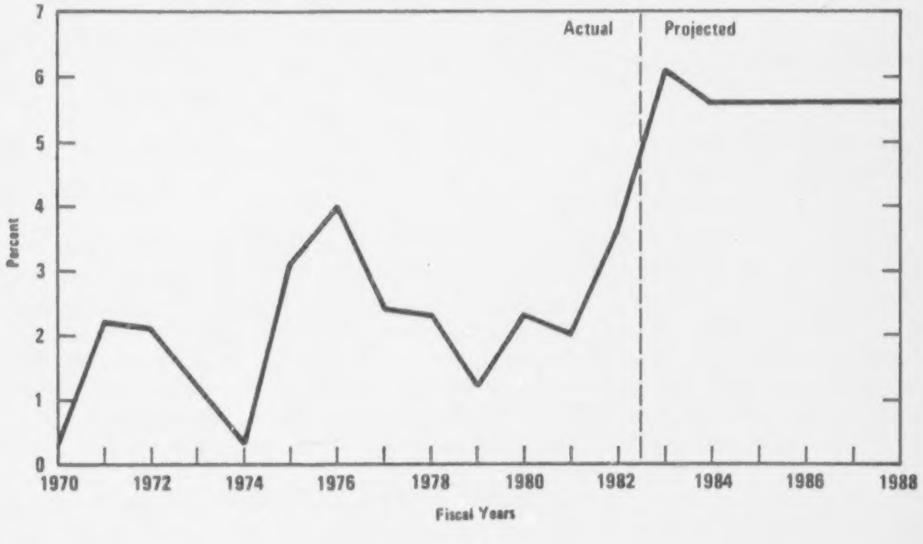
[By fiscal year, in billions of dollars]

	1983 base	1988 projection	Change	Cumulative 5-Year change 1984-88
National defense	213	358	144	456
Entitlements and other mandatory spending:				
Social security benefits	168	232	64	186
Medicare and medicaid	76	142	67	181
Other entitlements	142	137	−6	−53
Subtotal	386	511	125	314
Nondefense discretionary spending	145	184	39	120
Net interest	87	134	47	144
Offsetting receipts	−32	−41	−9	−32
Total	800	1,145	345	1,002

CBO expects the budget deficit for 1983 to be $194 billion, almost double the $104 billion target the Congress set last year in the budget resolution. Under CBO's baseline assumptions, it would remain at about the same level in 1984 and then grow gradually to nearly $270 billion by 1988. As a percent of GNP, the deficit would decline only slightly from its postwar high of 6.1 percent of GNP in 1983 to a relatively steady 5.6 percent over the 1984-88 period. (This can be seen in figure 2.)

Figure 2.

Federal Deficit as a Percentage of GNP

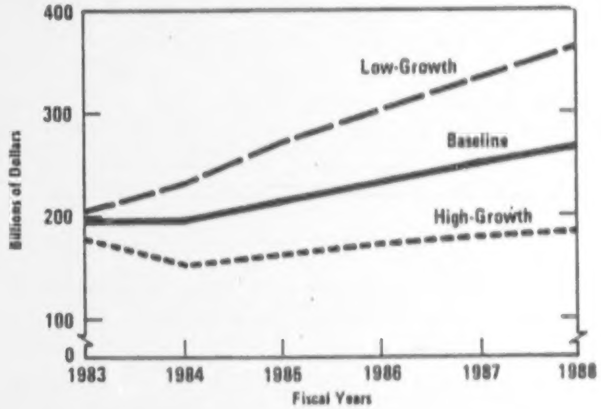


ALTERNATIVE ECONOMIC ASSUMPTIONS

Projections of the budget deficit are greatly affected by economic assumptions, even with tax and spending policies unchanged, as shown in appendix table 1 [1] and in figure 3, in which we show the impact of the high-growth scenario or the low-growth scenario in contrast to our baseline. But the point is that even under the "high-growth" economic path, the budget deficit would remain large throughout the projection period.

Figure 3.

Federal Deficit Under Alternative Economic Assumptions



THE CONSEQUENCES OF CURRENT BUDGET POLICY

Under any of these economic scenarios, the deficits projected for the outyears pose severe risks. One possibility is that the Federal Reserve, facing such large deficits, will not be able to maintain an anti-inflationary monetary policy; as a result, inflation may be rekindled. Alternatively (and I think more likely), the normal rise in business and consumer demand for credit during the recovery may collide with large Federal credit demands to finance the persistent deficits. The resulting increase in interest rates is likely to crowd out business investment. A low-investment economy reduces the chances for productivity growth. Failure to modernize equipment prevents our export industries from remaining competitive. In the long run, advances in the Nation's standard of living rely on the productivity growth and maintenance of trade that deficits over jeopardize.

NARROWING BUDGET DEFICITS

Substantial cutbacks in spending or increases in taxes in fiscal years 1983 or 1984 might delay or weaken the economic recovery. However, substantial reductions in the deficit over the entire 1984–88 projection period are needed if a balanced recovery is to be sustained and the low-investment scenario avoided. This points to the need for a multiyear plan that is devised and legislated this year. Prompt action must be taken both to ensure an orderly reduction in outyear deficits and to reduce the uncertainty about future fiscal policy. Before such a plan is embarked on, two broad policy choices have to be resolved.

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[1] See p. 364.

The first choice—one that the chairman raised in his opening statement—is to settle on a budget deficit target for, say, 1988. That target must be well below the baseline projection of 5 percent to 6 percent of GNP. Most of the responsible debate has centered on a range of target deficits by 1988 of between 1 percent and 3 percent of GNP. And the administration, as you know, is calling for a deficit target of 2.6 percent of GNP by 1988—under its economic assumptions. We have discussed these economic assumptions at some length in our economic report, and we could come back to those in the question period.

The second choice is whether the major deficit narrowing initiatives should emphasize spending cuts or tax increases. Obviously, either of these routes exacts real costs.

ILLUSTRATIVE MULTIYEAR DEFICIT REDUCTION PLANS

To indicate the magnitudes involved in these choices, part III "Reducing the Deficit: Spending and Revenue Options, February 1983" of CBO's annual report shows three illustrative budgetary plans designed to reduce the deficit gradually to 2 percent of GNP by 1988; this seems to us a reasonable target. The first plan—included here as figure 4—emphasizes tax increases—raising the tax burden to 21 percent of GNP by 1988, which is approximately where it was in 1981, and holding national defense spending to levels consistent with last year's budget resolution. Such an approach would imply a cumulative 5-year increase of more than $300 billion from the new tax initiatives, only about $60 billion of which would be furnished by enactment of the proposals advanced by the National Commission on Social Security Reform. Raising the additional revenues would require repeal of major provisions of ERTA, adoption of significant new tax sources, or a truly comprehensive broadening of the income tax base—some options for which are shown in appendix table 2.[1] On the other hand, this illustration would only require about $70 billion in nondefense spending cuts—over and above the Social Security Commission's proposals and the debt service savings made possible from lower deficits—over 5 years, which is well within the bounds of recent experience. [Appendix table 2 lists some options.]

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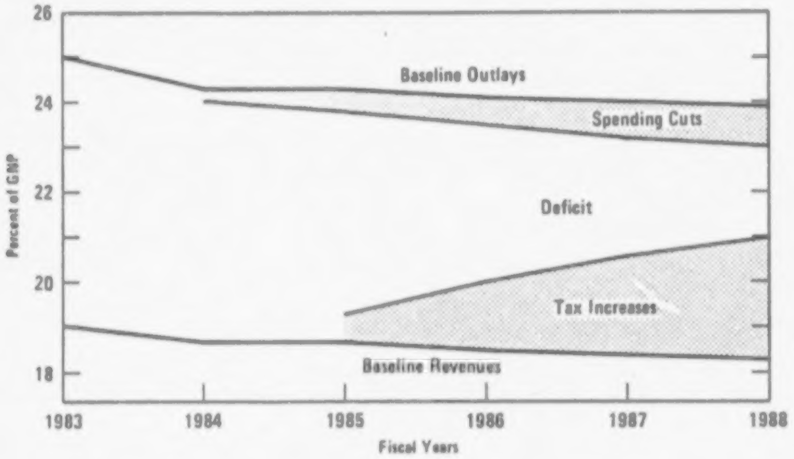
[1] See p. 365.

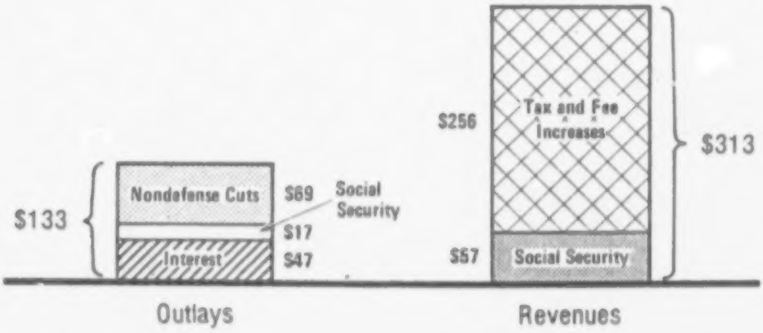
Figure 4.

Strategy Example 1—Restore Tax Share to 1981 Level, Maintain Baseline Projection for Defense



Cumulative Savings 1984-1988

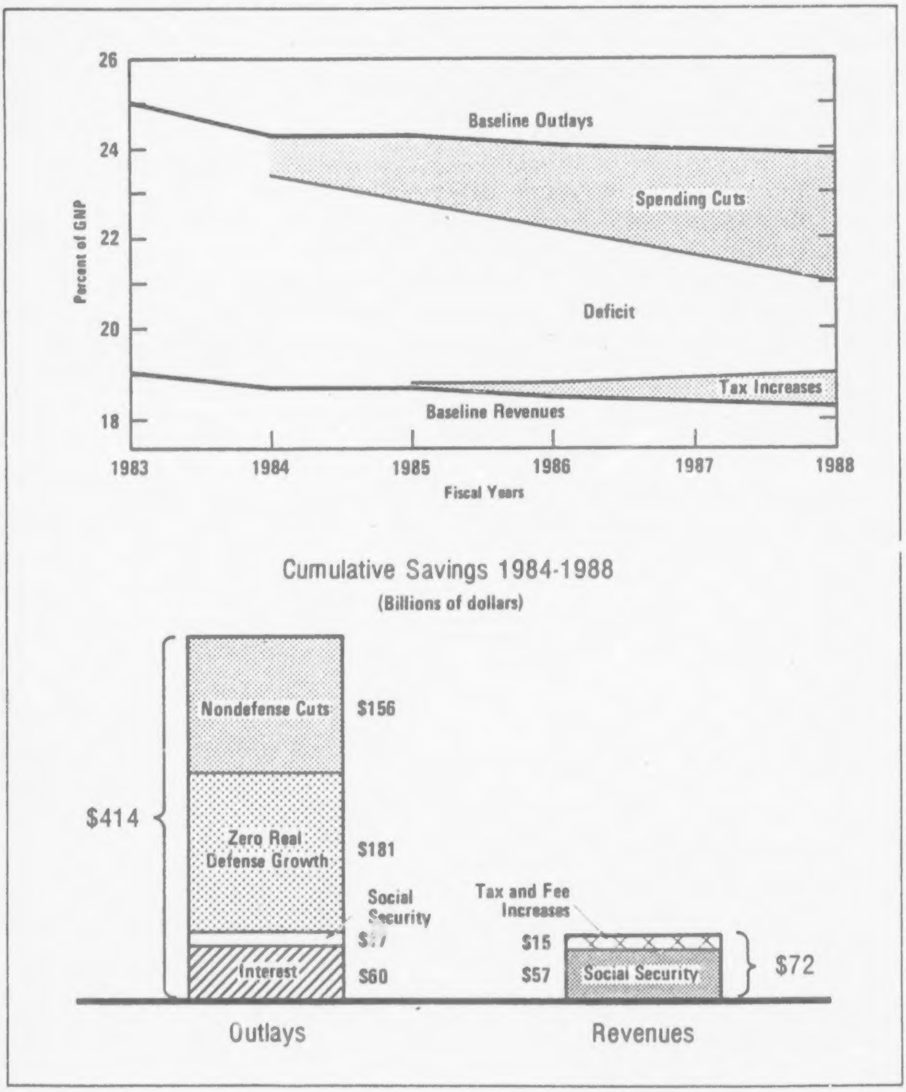
(Billions of dollars)



Alternatively, if revenues were allowed only to creep back to the current level of 19 percent of GNP, the need for spending reductions would be extreme [see figure 5]. More than $300 billion in program cuts would be needed over the 1984-88 period—beyond social security reform and interest savings. Curbing defense growth sharply—by holding budget authority for national defense to zero real growth rate—which nobody is talking about that I know—could furnish almost half of the needed deficit reduction; but that would still leave $150 billion to be recovered in nondefense cuts. Even if all cost-of-living adjustments in social security benefits were held to 2 percentage points below inflation, and if all nondefense discretionary programs were frozen at current levels—both measures assumed effective for 5 years—the cumulative savings would fall far short of the mark [see appendix table 3]. Such draconian cuts in domestic programs and reversals of defense growth are unlikely to gain broad support. (That may be the understatement of the week.)

Figure 5.

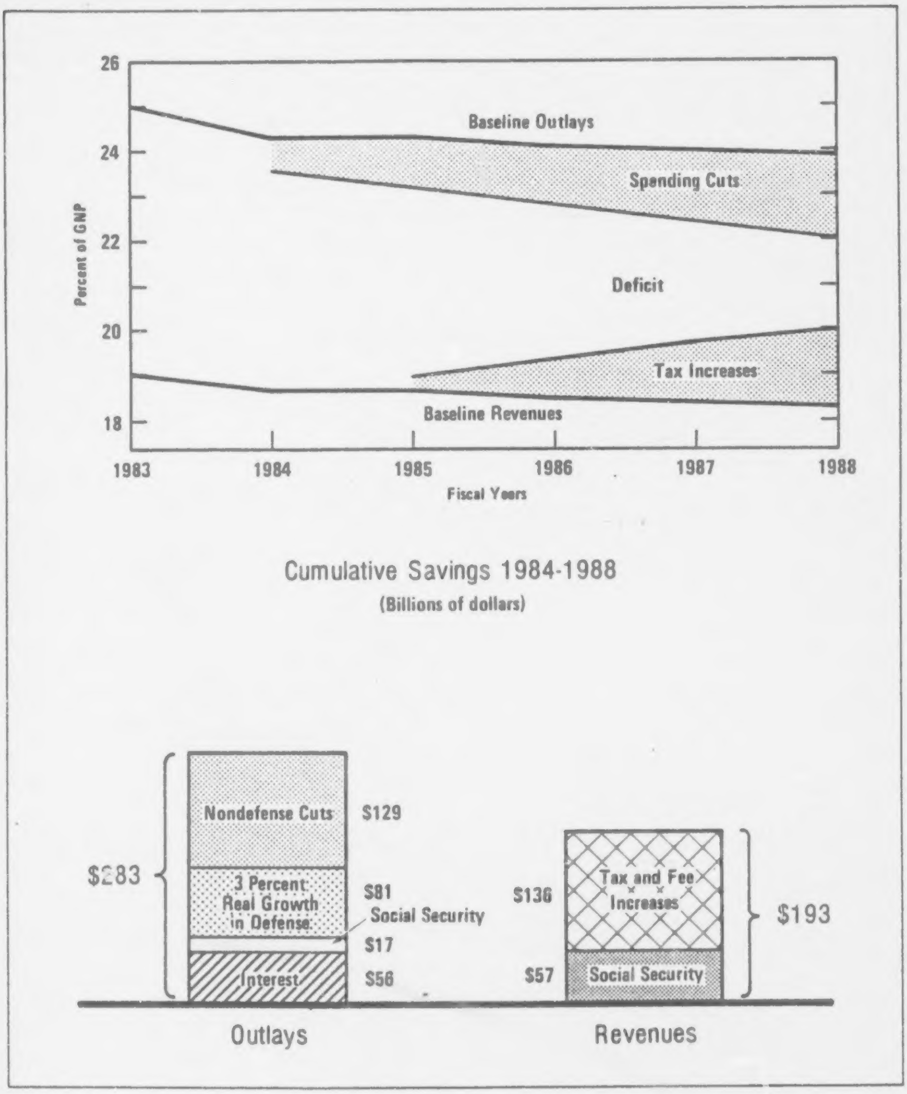
Strategy Example 2—Freeze Tax Share at 1983 Level, Cut Government Spending



A reasonable conclusion to draw from these illustrations is that a deficit reduction plan will have both to raise taxes significantly and make major spending cuts. In one such plan—illustrated in figure 6—taxes are gradually raised to the intermediate level of 20 percent of GNP, and spending is brought down to 22 percent of GNP in 1988. In this alternative, significant tax and spending legislation would be needed; but some flexibility of choice would be preserved. For example, on the revenue side, repeal of indexing of the individual income tax and a small assortment of base-broadening options could bring taxes up to the required level [see appendix table 2]. Several alternate outlay packages that accumulate to about $200 billion in savings—after social security and interest savings—could be devised. For example, the figure shows that limiting national defense budget authority growth to 3 percent after inflation would contribute about $80 billion in savings from the 1984–88 baseline, and several less extreme reductions—in medicare and other entitlement programs, for example—could supply the rest.

Figure 6.

Strategy Example 3—Raise Tax Share to Intermediate Level, Limit Defense to 3 Percent Real Growth

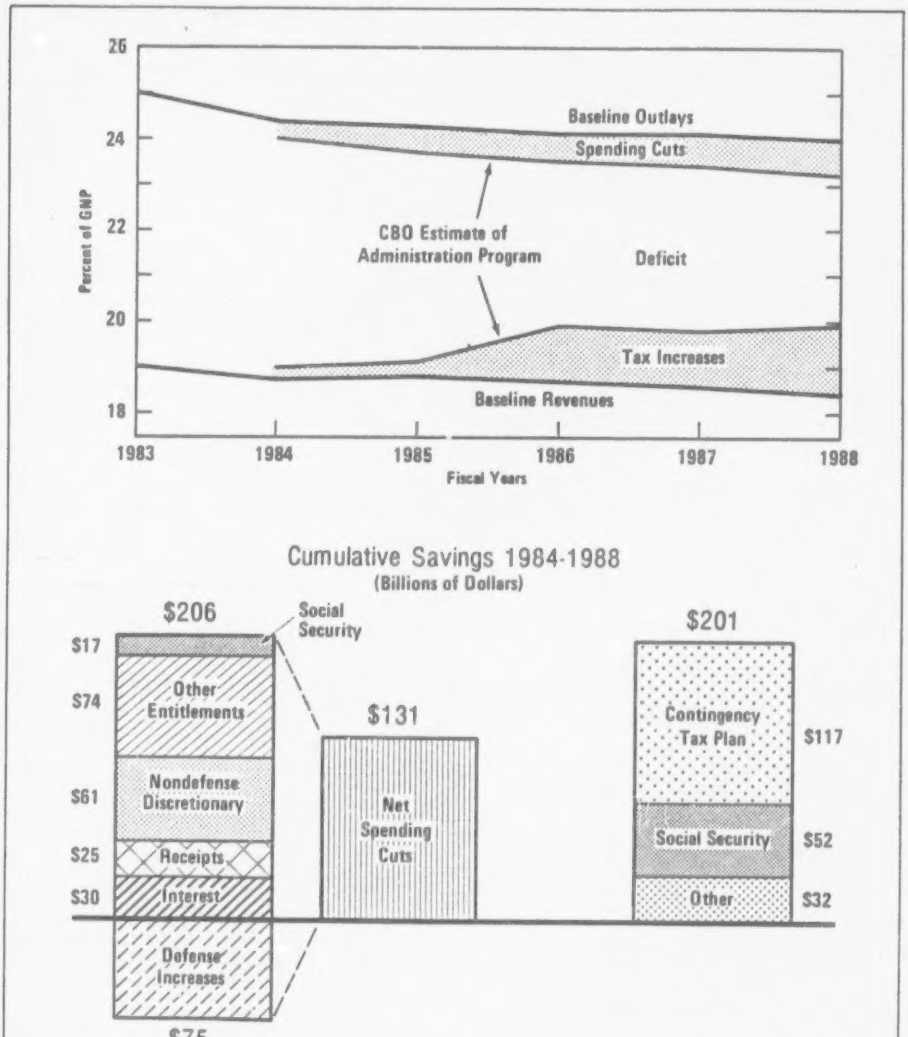


THE ADMINISTRATION'S BUDGET PLAN

We hold no brief for any of these options. They are simply to outline the magnitude of the problem.

The administration's recently submitted budget would narrow the deficit by a somewhat smaller amount, and the composition of that budget is strikingly different. The proposal—depicted in figure 7—includes substantial tax increases, with the tax share estimated by CBO, under our baseline economic assumptions, to rise to 20 percent of GNP in 1988. Most of the new revenue is derived from the contingency tax plan of an income tax surcharge and a petroleum tax. The net outlay reduction in the administration's program is at the lower end of the range of the alternatives CBO has been illustrating, but the composition of the proposed spending cuts is quite different.

Figure 7.
Administration's Budget Program



SOURCE: Congressional Budget Office.

Relative to the CBO baseline projections, the administration is requesting a substantial increase in defense spending—some $75 billion over the 1984-88 period. The defense increase simultaneously raises the gross spending reductions needed, and it restricts cutting to the nondefense side. CBO's estimates indicate that the cumulative reductions in entitlement programs other than social security would come to about $74 billion, and in nondefense discretionary spending to about $61 billion. These cuts represent more than half of all projected spending growth after 1983 in the CBO baseline for these categories.

CONCLUSION

It is now widely agreed that spending cuts and tax increases will be needed to reduce the projected deficits to acceptable levels when the economy has recovered. While prompt action will be needed to achieve desired deficit reductions in the outyears, balancing this consideration against the need to allow sustained recovery will be difficult; some spending cuts and tax increases may have to be put off to permit recovery to gain momentum. An appropriate deficit reduction program requires a multiyear plan—legislated this year—with a balanced mix of tax increases and spending reductions. I hope our recent reports and continued assistance can help the Congress put together such a plan.

Thank you, Mr. Chairman.

Senator GORTON [presiding]. Thank you, Dr. Rivlin.

APPENDIX TABLE 1.—BASELINE BUDGET PROJECTIONS UNDER ECONOMIC ASSUMPTIONS, FISCAL YEARS 1983-88

	1983 base	Projections				
		1984	1985	1986	1987	1988
	In billions of dollars					
High-growth path:						
Revenues	615	676	742	798	862	933
Outlays	793	830	904	971	1,041	1,116
Deficits	178	155	162	172	179	183
Low-growth path:						
Revenues	599	636	686	730	777	825
Outlays	804	868	958	1,032	1,110	1,187
Deficits	205	232	272	302	333	363
	As a percent of GNP					
High-growth path:						
Revenues	19.0	18.7	18.7	18.4	18.3	18.1
Outlays	24.4	23.0	22.8	22.4	22.1	21.7
Deficits	5.5	4.3	4.1	4.0	3.8	3.6
Low-growth path:						
Revenues	18.9	18.7	18.6	18.5	18.4	18.4
Outlays	25.3	25.5	26.0	26.1	26.3	26.5
Deficits	6.5	6.8	7.4	7.6	7.9	8.1

APPENDIX TABLE 2.—MAJOR TAX INCREASE OPTIONS, FISCAL YEARS 1984–88

[In billions of dollars]

Option	1984	1985	1986	1987	1988	Cumulative 5-year increase
Repeal parts of ERTA						
Repeal parts July 1, 1983, rate reduction	30	33	35	38	40	177
Cap 3d-yr tax rate cut at $700	6	7	7	8	9	37
Repeal indexing		6	17	28	40	90
Initiate new tax sources:						
10-percent value-added tax			150–200 per year			
Energy tax			10–20 per year			
Possible base-broadening options [1]:						
Tax some employer-paid health insurance	3	5	6	7	9	30
Eliminate deductibility of State and local sales taxes	1	6	6	7	8	28
Limit nonbusiness, non-investment interest deductions to $10,000	1	2	2	2	2	9
Lengthen building depreciation period to 20 yr	(2)	2	4	6	8	19
Require full-basis adjustment for the investment tax credit	(2)	1	2	4	5	12
Tax nonstatutory fringe, benefits	1	1	1	2	2	6
Freeze estate and gift tax credit at exemption equivalent of $275,000		1	1	2	3	6
Social Security Commission proposal	9	6	9	10	23	57

[1] Assumes Jan. 1, 1984, effective dates.

[2] Less than $0.5 billion.

Source: Congressional Budget Office, "Reducing the Federal Deficit: Spending and Revenue Options" (February 1983).

APPENDIX TABLE 3.—MAJOR OUTLAY REDUCTION OPTIONS, FISCAL YEARS 1984–88

[In billions of dollars]

Option	1984	1985	1986	1987	1988	Cumulative 5-yr savings
National defense:						
3 percent real growth	4	16	23	19	19	81
5 percent real growth	2	10	12	2	−6	20
Social security:						
Reform commission	2.9	3.1	3.5	3.7	4.0	18.6
Cap COLA at CPI growth less 2 percentage points	4.2	7.8	11.5	15.3	19.1	57.9
Medicare:						
Expand hospital coinsurance days 2–30	2.0	3.0	3.4	3.8	4.3	16.5
Move to prospective hospital reimbursement			2.1	4.1	4.6	10.9
Increase SMI premiums	.9	1.1	1.7	2.5	3.4	9.6
Entitlements: Eliminate all COLA's (including social security)	11	23	34	46	58	172
Nondefense discretionary:						
Limit increase to 2 percent nominal per year	.8	2.4	4.2	6.2	8.3	21.9
Freeze program funding at 1983 levels	2.1	6.0	10.6	15.6	20.7	55.0

Source: Congressional Budget Office, "Reducing the Federal Deficit: Spending and Revenue Options" (February 1983).

CURRENT POLICY DEFICITS NOT CONSISTENT WITH GROWTH

Senator GORTON. I will say for this Senator, we are going to miss you. I hope you are around with us for awhile longer.

If I may, you have given us, in a set of projections, both what you think the most likely economic growth, CPI increase, et cetera, is for the next year and a so-called high growth and low growth alternative.

What kind of budget will we have with your actual midline CBO set of figures? A budget which is simply current policy, the President's budget, or one of the alternatives which you have just discussed here?

Dr. RIVLIN. Our baseline economic projection in the near term—that is, 1983-84—assumes current policy on the budget.

After that, our economic scenario is simply a projection that continues the growth of the economy at what we feel to be feasible rates, but not necessarily consistent with a continuation of current policy. In fact, I think my remarks would indicate that I do not think that it is consistent.

Senator GORTON. In other words, the current policy deficits which you outline are not consistent with the kind of growth that you have outlined.

Dr. RIVLIN. It is my view that if we do not get the deficit substantially below where they would be under current policies, we will not have sustained growth at the level projected either by the CBO or by the administration.

Senator GORTON. And thus, in all probability, the low growth alternative would be more likely where we would go?

Dr. RIVLIN. It could be worse.

Senator CHILES. It could not even be that, if you have those baseline——

Senator GORTON. I think that may very well be the case.

Dr. RIVLIN. That is right. I think the danger is that with those kinds of deficits, you would have another run-up in interest rates, and then you would have a turn-down in the economy again.

HIGH-GROWTH SCENARIO

Senator GORTON. Let me pursue that question with you a little bit further.

Your high growth alternative is most likely to be attained by which of the projections of the growth of spending, deficits, taxes, so on, which you have outlined in the latter part of your testimony? What do we have to do, in other words, to get your high growth scenario?

Dr. RIVLIN. To maximize the probability of the high-growth scenario, you have to get the outyear deficits down somehow. There can be different ways of doing it, and the mix may not make so much difference. But either spending cuts or tax increases—or as we suggest, most probably a combination of the two—are necessary to increase——

Senator GORTON. All right. Let me follow that up.

You have one alternative which is mostly tax increases. You have one alternative which is mostly spending cuts.

Dr. RIVLIN. Right.

Senator GORTON. You also include the administration's alternative which are a mix of spending cuts, but they are a different kind of mix.

Dr. RIVLIN. Yes.

Senator GORTON. Could you outline to me how you think our choice of deficit reduction among those alternatives is likely to impact the growth of the economy?

Does it not make any difference from the point of view of economic growth?

Dr. RIVLIN. I think it does make some difference, and I think that—although it would matter how you did the tax increase—loading it all on the tax side would make high growth less likely.

Senator GORTON. Does that mean that loading it all on the spending side would make high growth most possible but it is just politically not feasible?

Dr. RIVLIN. Not necessarily. I think to take that many spending cuts might well have dislocating effects on the economy.

Senator GORTON. So you would not only prefer individually, but you think that the most likely scenario for strengthening the economy would be by your combination of these cuts for tax increases.

Dr. RIVLIN. I think that the least risky alternative is probably one in the middle, which raises taxes some and cuts spending some, and does not take drastic measures on either end. It is very hard to prove that, but that seems to me the least likely to be very disruptive.

BE CAUTIOUS ABOUT RAISING TAXES OR SPENDING CUTS IN 1984

Senator GORTON. Assuming a relatively responsible fiscal policy put into effect by legislation which takes place this year, but which may not actually take effect until, say, fiscal year 1985 or sometime in 1984, are you telling us that the best course of action for fiscal year 1984, for the binding parts of our budget resolution activity here, would neither substantially cut the amount of spending projected either in the President's budget or even on a current policy guideline from the point of view of either taxes or spending? Are you saying that for 1984 we should neither substantially cut spending nor increase taxes?

Dr. RIVLIN. That is the hard question.

I think there is no question that for 1983, you would be taking some risk of delaying or aborting the recovery if you did anything drastic to cut spending or raise taxes. The question is 1984; I would be very cautious about drastic moves to raise taxes or cut spending in 1984. However, I think you need to make very clear that the action to take place—the action that will get the outyear deficit down—is for real and will be sustained.

Senator GORTON. But your high growth line, you do believe to be consistent with budget deficits of $175 to $225 billion as long as we are making an enforceable promise for the outyears?

Dr. RIVLIN. There is no way to prove that. I hope so. I believe, as I said earlier, that the way to maximize the chances of getting a high-growth economy is to get those budget deficits down. Nobody can guarantee it or say that it is absolutely consistent. A lot also depends on monetary policy, which we have not discussed here.

Senator GORTON. Mr. Chairman, should I defer now to you or to Mr. Chiles?

Chairman DOMENICI. Mr. Chiles.

Dr. RIVLIN. Good morning, Mr. Chairman.

Chairman DOMENICI. Good morning.

TOTAL REVENUE, SPENDING, AND DEFICIT ESTIMATES

Senator CHILES. Dr. Rivlin, CBO has had 2 weeks to look at the President's budget and you give us some description of his deficit reduction in your statement, you point out that his proposals only bring revenues to 20 percent of GNP in 1988 compared with spending of over 23 percent. I know that your baseline estimates of revenues are $27 and $49 billion below his in 1987 and 1988 so that would clearly make your deficit projection higher.

You also point out that relative to the baseline, he proposes to add $75 billion in defense outlays over the next 5 years. While those 5-year totals are important in setting fiscal policy, we have to worry more about the deficits in 1984, 1985 and 1986 when the economy is on the upside of the economic cycle.

Would you tell us what your estimates are of total revenue, total spending and total deficits for each of the next 5 years if we adopt the President's basic budget proposal?

Dr. RIVLIN. I am going to tell the Appropriations Committee that at 10 o'clock tomorrow morning, and I do not actually have the numbers. I had expected to have that report, but we got slowed down by the blizzard. I can tell you roughly where we are, though.

The CBO does not have major differences with the administration on the estimates this year. And the ones we do have reflect the differences I already discussed between the economic paths. We are slightly more optimistic in near term, slightly less in the outyears. That means that our estimates of deficits, whether baseline or the President's, are slightly smaller in the near term and slightly larger in the outyears.

Last year, you will remember, in addition to differences over economic assumptions, we had major technical differences in estimating techniques with the administration that affected the outcome. This year, there are technical differences—there always are—and we have found some inconsistencies in the administration's submission, but they approximately wash. They do not change the bottom line very much. The numbers as reestimated by us are very close to what the administration is saying; the differences largely reflect the differences in economic path, which are, I must emphasize, not large as these things go.

TAX CUTS DID NOT IMPROVE ECONOMY

Senator CHILES. All right.

During the last 2 years, we passed legislation to drastically reduce taxes. But the 5 percent cut in personal taxes that was effective in October 1981 and the subsequent tax cuts of 10 percent in July 1982 did not seem to do anything to improve the economy, and those cuts only added to the deficit and they keep the interest rate high. Yet I keep hearing you and others saying that we should not, and I quote, "raise taxes now for fear of choking off the recovery." But that we should raise taxes in a year or two.

Let me ask you this. If the third round of the tax cut was not already written into law and we were sitting here with a $200 billion deficit, would you be recommending that we pass a permanent tax cut of $30 billion to stimulate the economy this summer?

Dr. RIVLIN. Senator Chiles, I never recommend anything.

Senator CHILES. Well, would that be good economic policy?

Dr. RIVLIN. I think I would probably point to the risks of escalating the deficit and against the possibility of stimulating the economy more. At the moment, we have a very stimulative fiscal policy already in place and I think there are risks to increasing the deficit any more.

PRIME RATE IS MAJOR OBSTACLE TO ECONOMIC GROWTH

Senator CHILES. I just—the only thing I would say to you, one thing more, Alice, and remember you are not staying around now, you can tell all now.

The prime rate is currently 11 percent—and I am disappointed with that also, I must say, that you are not staying around. The prime rate is currently 11 percent and triple A bond rate is 12 percent, and inflation around 4 to 5 percent; that leaves real interest rates 6 to 7 percent. That certainly has got to be one of the major obstacles to sustained economic growth.

Dr. RIVLIN. Absolutely.

Senator CHILES. Could not the administration and the Federal Reserve lower the real interest rates if they wanted to to provide economic growth?

Dr. RIVLIN. I do not think there is anything that the administration could do. The question of what the Federal Reserve could do is interesting, and I think that is a good subject for conversation with Chairman Volcker.

It is our perception that the Federal Reserve is proceeding cautiously but with the aim of getting interest rates down some more and certainly not allowing them to increase as the recovery takes hold. It is not clear that they have very good instruments to do that.

COST GROWTH EXISTS IN WEAPONS SYSTEMS

Senator CHILES. Secretary Weinberger and others have represented the defense budget as providing 7 percent real growth. When we look at those numbers, we see that the progam is loaded at the front end with high growth rates approaching 10 percent in 1983, 1984 and 1985. Low rates dropping toward 4 percent in 1986, 1987 and 1988. We also have heard a lot about historical trends, weapons procurement and crossgrowth; former Joint Chief of Staff, General Jones, testified that the Department's procurement program was underpriced by several hundred million dollars. We keep getting fragments from Mr. Spinney's report. The Heritage Foundation seems to agree as well.

I am concerned as we move to the outyears we are never going to get to the low 4 percent end of that curve, and the procurement programs will be repriced and those high growths that we are experiencing will now continue. What we may have here is not a program providing 7 percent real growth but one providing 10 percent real growth over the next 5 years.

How do you come down on that assessment, Dr. Rivlin?

Dr. RIVLIN. Well, there clearly is that danger. If you look at historical cost growth, as Mr. Spinney did and as others have done—as we have done sometimes as well—you see that, in most weapons systems, costs, there has been substantial growth beyond what is explained by inflation. If that were to occur in the future, clearly there would be substantial additions to the costs now projected.

We have looked at this, but we are not prepared to make a prediction about that. Certainly the risk is there. I think the good news about this year's defense budget is that it does appear to be fully funded for inflation in the next few years. In the past, the Defense Department has often underestimated inflation, at least by comparison with what we thought. This year it does not seem to have done that. But the possibility of real growth in weapons systems costs, in continuation of historical trends does exist.

Chairman **DOMENICI**. Senator Metzenbaum.

PRICES HAVE NOT COME DOWN

Senator **METZENBAUM**. Thank you, Mr. Chairman.

Dr. Rivlin, I interrupted your remarks, your basis of questioning of the manner of one assertion the President made, that is that the tax reductions had increased investment because I did not think they had, and you confirmed that to your knowledge they had not; that based upon the facts, they had not.

The President also has been addressing himself to programs having reduced the rate of inflation and it is my understanding that in your report you indicate that a significant proportion of the changes in consumer prices can be accounted for by the changes in oil prices, both directly in gasoline and fuel oil prices, and indirectly in the cost of oil used to produce other things.

I just came back from Ohio and I went to the supermarket and I did not see that bread had come down or that milk had come down. I did not see that clothing had come down. I did not see that anything had come down that I could see, any prices except for the price of gasoline.

Now, would you address yourself to the question of whether prices have indeed come down and whether or not the whole question of inflation being under control is or is not a reality at this time?

Dr. **RIVLIN**. Senator, prices on the average have not come down. They are rising at a slower rate; that is the good news. The rate of inflation—the rate of increase in consumer prices and other prices—has slowed dramatically. It is less than half of what it was a year or so ago. I think that has multiple causes. It is partly the slowdown in the economy itself, which has just put less pressure of demand on supply and has brought wage level increases to lower rates. It is partly the international oil situation, the reversal of the increases in energy prices; indeed, one of the few prices that has actually come down is gasoline. It is partly the food price situation, which has put a lot of pressure on farmers but has meant that there has been less increase in food prices than in the past.

Senator **METZENBAUM**. Even their prices have not actually come down.

Dr. **RIVLIN**. Prices in general have not come down. Now, some prices have come down. The price of money has come down. One of the contributions to the falling rate of inflation has been declining interest rates, especially mortgage interest rates. They have not come down as most of us would like, but they have come down.

But very few prices have actually come down. What is regarded as a success is a cut in the rate of increase.

INCOME DISTRIBUTION OF CUTS

Senator METZENBAUM. Now, the administration has also told us that their budget does not hurt the poor. Yet the Center on Budget and Policy Priorities says it cuts programs targeted 40 percent since 1981, the President goes on the national radio, national tube, and says his programs are not unfair.

Would you address yourself to the question of the cuts in programs affecting the poor as related to other parts of the budget?

Dr. RIVLIN. We have not done a new analysis of the income distribution of cuts, Senator. In the first round of cuts, many of the means-tested entitlement programs, as opposed to non-means-tested entitlement programs were cut back—medicaid, food stamps, and welfare programs. But we have not looked at an income distribution of cuts in the proposed budget at all.

TAXES HAVE NEGATIVE IMPACT ON BUYING POWER

Senator METZENBAUM. In the 1981 tax cut bill, we reduced taxes over a period of 5 years about $750 billion. We have reduced the maximum tax from 70 percent to 50 percent; we have reduced capital gains from 28 to 20; we have reduced estate and gift taxes from—to a point where only three-tenths of 1 percent of the total population—total number of States was paying any taxes, and now the President, in order to explore new avenues for taxes, in order to help balance the budget, has first come back with crippling of the telephone tax, doubling of the cigarette tax, now has talked about a consumer tax, talked about a 12-cent-a-gallon tax on oil, standby basis, and has talked about a surcharge on income taxes, and talked about a tax on unemployment compensation.

It is not the fact that just about every one of the taxes that the President has thrown up as a balloon, or one of his spokespersons has raised as a possibility or has sent to the Congress as a standby tax, is it not the fact that each of those taxes would in and of itself be a deterrent to economic recovery and economic growth in this country because it would impact upon the consumer dollar?

Dr. RIVLIN. There is no good tax, Senator. There just is not a one. Certainly, any tax puts some drag on economic activity, but the reason for proposing them is that the alternative—mainly the higher deficits that also threaten economic growth—seems worse.

Senator METZENBAUM. But that is not my question.

My question is is it not the fact that each of the taxes that the President has proposed or sent out a balloon, each of those would have a negative impact upon buying power in this country and therefore have a negative impact upon the economic recovery?

Dr. RIVLIN. Well, the taxes you mentioned are consumption taxes, but any tax has a negative impact on buying power. The major tax increase proposed in the President's budget is a surtax on the income tax.

Senator METZENBAUM. And the 12-cents-a-gallon tax on gasoline?

Dr. RIVLIN. And the $5 a barrel oil tax.

Senator METZENBAUM. I thank you, Mr. Chairman.

Chairman DOMENICI. Senator Riegle.

SLIGHTLY WEAKER RECOVERY PROJECTED WITH CURRENT INTEREST RATES

Senator **Riegle**. Thank you, Mr. Chairman.

If interest rates stay at their current levels, with the prime at 11 percent, and we have had a recent uptake in longer term rates, as you know, which is a source of concern to all of us who follow it, if interest rates stay where they are now, what kind of recovery are we likely to be able to hope for through the rest of this year and beyond?

Dr. **Rivlin**. Our projection does call for interest rates coming down somewhat from where they are, and I share your distress at the fact that they do not seem to be doing that at the moment. If they do not, if they stay at current levels rather than come down, I guess we might project a slightly weaker recovery than we currently do.

Senator **Riegle**. Let me pursue it a little further because I think that is really a critical issue for us right now, and that is if interest rates do not come down as you forecast, that you hope and think they will, what the consequences would be; in other words, when you say we would not have as good a picture, can you be more specific? I mean if interest rates stay where they are now, we rock along at this level, what is that going to mean for unemployment's sake and what is it going to mean for real growth out over, say, the next 6, 12 months?

Dr. **Rivlin**. I cannot really be more specific than that. Higher interest rates are not good for economic growth. At best, if you follow the scenario that we have laid out—which calls for 4 percent growth between the end of 1982 and 1983, and which was predicated on interest rates coming down some more—even that projection does not allow unemployment to come down very much. So a weaker growth rate would mean slightly higher unemployment.

Senator **Riegle**. Now, when you are expecting interest rates to come down further, where are you expecting the prime to go? What is built into your projection?

Dr. **Rivlin**. I do not know what we have on the prime, if we forecast it. We do, as I said in my statement, have short-term rates for 3-month Treasury bills—coming down to 6.8 for the average for this year. The rate is higher than that now, so that they speak of some drop this year.

INTEREST RATES EXPECTED TO COME DOWN

Senator **Riegle**. Now, you said at the outset when I posed this to you, that you are a little uneasy about the fact that the rates have recently trended up rather than trended down.

Dr. **Rivlin**. Sure.

Senator **Riegle**. What is going to bring them down in your opinion? Why are they coming down?

Dr. **Rivlin**. Well——

Senator **Riegle**. What do you base that expectation on?

Dr. **Rivlin**. The basis of our expectation that they would come down—especially long-term rates—is the continued perception that inflation is coming down. It is something of a mystery why long-term rates have stayed so high while inflation has in fact come down. The usual explanation is that the market does not believe that inflation will in fact stay down, and that it is very apprehensive about the future of the economy, the future of deficits, the deficits themselves. The prospects of future deficits have kept those long rates higher than they otherwise would be.

I think some credence has to be given to that, and that getting the rates down will require combined actions of both the Congress and the Federal Reserve—the Federal Reserve not tightening up on the money supply, doing what is necessary to keep the rates coming down, and the Congress getting the outyear deficits down.

INTEREST RATES AFFECTED BY OTHER FACTORS

Senator RIEGLE. Might it be that interest rates are not tied as directly to inflation? I mean obviously tied to inflation to some extent but perhaps not tied to inflation as much as we have led ourselves. to believe. Maybe interest rates are driven as much or more by other factors.

Dr. RIVLIN. Well, there are lots of factors affecting interest rates, and they certainly are——

Senator RIEGLE. Let me just give you one to think about.

Obviously right now we have a lot of foreign dollars. We had testimony yesterday in the Banking Committee from Secretary Regan to the effect of increasing our commitments to the International Monetary Fund because there are a lot of countries in the world that are running out of money and desperately need money for a variety of purposes, and there are all kinds of things bearing in on aggregate credit demand and credit use. And it may well be that we have gone so far in linking interest rate levels to inflation rates that we are missing other factors that are at work here. Because I do not think it is enough to say it is a contradiction and go on to the next subject. In other words, the contradiction between the rates of interest that are being charged and the inflation rate. The fact that we have had this gap opened up, the real rate of return above inflation and maintain itself for a long period of time with so much slack in the economy, with a third of the—of the plant and equipment and shutdown and 12 million people out of work, currently it does not add up, and the thing that disturbs me here is I am disturbed that you may be forecasting lower interest rates that may not materialize. I hope they do materialize. We desperately need them, too, but I am still not clear on what you base that forecast because if that forecast is wrong, if you are incorrect on your interest rate assumption and the interest rates dropping further, then that knocks everything else really off kilter here.

Dr. RIVLIN. Well, we have certainly warned about that, and we have warned particularly about the increasing deficits and the risks they pose to the economy, and particularly the upward pressure that they put on interest rates.

I think the situation is very complicated, especially internationally. In general, however, we have benefited from a recent influx of capital into the United States from foreign sources, without which our interest rates would probably be higher than they are now. That is occasioned by the fact that, not only do we have high real interest rates—this is a good place to invest your money—but also there seems to be a political perception that we are more stable than other places.

GOVERNMENT BORROWING RATE

Senator RIEGLE. When do you see the Government borrowing rate getting down to 6.8 percent? When does that forecast, I mean, when you say——

Dr. RIVLIN. That was an annual average for 1983.

Senator RIEGLE. Annual average for 1983. And where are we now?

Dr. RIVLIN. Short-term Treasury bills are a little over 8.

Senator RIEGLE. I think they are in the range of maybe 8½. I am not sure of the percentage.

Dr. RIVLIN. 8.2, I think.

Senator RIEGLE. We are in the middle of February so if we are going to get down to a 6.8-percent annual average, there has to be pretty quick and substantial drop in that range.

Do you still think that is going to happen?

Dr. RIVLIN. They are a little higher now than they were.

Senator RIEGLE. Do you still feel comfortable sitting here right now saying your best judgment is 6.8 for the year?

Dr. RIVLIN. I do not feel comfortable about interest rates at all. I do not think anybody does.

But it seems most likely to us, given monetary policy and given what has happened to inflation, that interest rates will come down somewhat in 1983, although we expect short-term rates to come up a little bit in 1984 as the recovery takes hold.

Senator RIEGLE. What do you expect the Fed to do? I mean as you build this 6.8 percent, does that anticipate some further easing, accommodating by the Fed?

Dr. RIVLIN. Our expectation is that the Fed will do what is necessary in their view to accommodate a moderate recovery. And exactly how they will do that is another question because the monetary aggregates are very hard to interpret.

AVERAGE PRIME RATE NUMBER

Senator RIEGLE. What is your prime rate number that you are anticipating is the average annual rate increase?

Dr. RIVLIN. I do not have a prime rate number but I could supply that for the record.

[The following was subsequently supplied for the record:]

CBO does not forecast the prime interest rate per se, because it is not used in the budget process. However, a prime rate of perhaps 9.5 to 9.8 percent for the year (1983) would be generally consistent with past relationships with the three-month Treasury bill rate, which CBO does forecast.

Senator RIEGLE. It is 11 now. Would it be at least a point and a half below that probably?

Dr. RIVLIN. I think so, but I do not remember.

Senator RIEGLE. Because I think again—I must say I want to believe that that can happen, too, and will happen, but I cannot get my hands on anything that lets me plausibly expect that that is what we are going to see take place here. It seems to me if the economy does start to move and auto sales go up and housing sales go up and other things, that credit demands are going to rise, that the Government is coming in with very substantial borrowing needs of its own, you have lots of rollover loans that have to be accommodated from people who went into short-term housing notes with adjustable rate mortgages, other lenders, commercial lenders that have to roll over their loans. You have the international financial requirements, and unless you are anticipating a major breakthrough on the budget or a major accommodation and perhaps, in addition, a major accommodation by the Fed, I am just hard pressed to see how you come up with that interest rate forecast. And as you point out, last year you thought interest rates were going to come down further and it did not happen.

Dr. RIVLIN. Well, last year, everybody thought that, including the Federal Reserve.

MONETARY POLICY DIFFICULT TO DETERMINE

Senator RIEGLE. I understand. I am not saying you were the only one that miscalculated.

But my point is that the most recent experience is that you thought there were going to be lower interest rates and it did not happen. I am just wondering, I think now because these decisions are so critical that there is a greater requirement to be able to pinpoint why you feel rates are going to come down now. I think you have to take the next step and be a little more specific in terms of what you base that judgment on because if rates do not come down, then we face quite a different picture than the one that would—a more pleasant one to expect.

So I would like you, if you would, to see if you cannot give us more on that.

Dr. RIVLIN. We cannot be very much more specific on what the Federal Reserve will do.

Senator RIEGLE. No. It is what you expect——

Dr. RIVLIN. It is very difficult for anyone, I think—probably including the Federal Reserve itself—to spell out exactly what monetary policy will be. We have simply taken the Federal Reserve at its word. The chairman has said that they want a moderate recovery, and our assumption is that they will do what they can to bring that about.

Senator RIEGLE. Well, if you are going to give us a number on the prime rate expectation as the average for 1983, but you thought it would probably be in the magnitude of a point and a half less what it is now——

Dr. RIVLIN. I did not really give you an estimate. I will supply it for the record.

Senator RIEGLE. I know. I supplied that and I asked you if you thought that was in the ball park, and I think you said it might be. I think those were your words.

In any event, if we are talking about something close to a 9½-percent prime rate as the average for this year, we are going to have to see some movement on interest rates pretty quickly here to bear that out. So I would like to ask you to do something else, and that is if rates stay where they are now, I would like to know how that affects your estimates on the deficit, employment rates, inflation rates. I would like you to just run your numbers based on a different assumption at current levels and see what that does to the bottom line.

Dr. **Rivlin**. We will have a try at that, Senator, but I do not think I can tell you anything more informative than I already have—namely, that higher interest rates will weaken the economy somewhat. That is the extent of our knowledge.

FORECAST BUILT ON MAJOR IMPROVEMENT IN INTEREST RATES

Senator **Riegle**. I am not trying to be contentious. I just want to make sure that you understand what I am after.

I am saying if we fix something like an interest rate floor right now, and in fact if we are not going to go appreciably lower, I want to know what that does to your forecast. You see, you are building your——

Dr. **Rivlin**. All I am saying is I cannot tell you——

Senator **Riegle**. You are building your forecast on major improvement in interest rates which we may or may not get. You thought we were going to get them last year; we did not get them last year. We may not get them this time. And I would just like to know if we do not get an improvement on interest rates, how that changes the bottom line then. That should not be that hard to do.

Dr. **Rivlin**. We will do the best we can.

Senator **Riegle**. Thank you.

[The following was subsequently supplied for the record:]

The CBO lower growth alternative projection assumes substantially higher interest rates than does the baseline projection (Table 2). Under the lower-growth alternative with higher interest rates, the three-month Treasury bill rate averages 8.4 percent in 1983—about where it is now—and 9.9 percent in 1984, which is 2.5 percentage points above the baseline projection. Compared to the baseline projections, real growth is reduced by more than one percentage point in both 1983 and 1984 (calculated year-over-year). The unemployment rate averages about one-half percentage point higher in 1983 and a full point higher in 1984. Inflation, as measured by the Consumer Price Index (CPI-U), is little changed. However, the budget deficit is substantially higher—about $35 billion higher for fiscal year 1984 (Table 4 and Appendix Table 1).

Chairman **Domenici**. Senator Biden.

Senator **Biden**. Thank you, Mr. Chairman. I have a statement that I would like inserted in the record.

Chairman **Domenici**. Without objection, it will be inserted at this time.

Prepared Statement of Senator Biden

I want to welcome you back to the Senate Budget Committee for your 10th year of testimony (if I may count your 1974 testimony when you were with the Brookings Institution.) You have been a part of the congressional budget process since its inception. Much of the credit for its successes belongs to you.

HIGH UNEMPLOYMENT

This is not a particularly happy occasion, marked as it is by a depressed economy, high unemployment and burgeoning deficits. It has been fashionable in the past few days to celebrate a four tenths of one percentage point drop in the civilian unemployment rate. The fact is we have extraordinarily high unemployment still, and even the celebrants do not predict its rapid decline.

Your annual report to the Congress features, appropriately, the problem of unemployment and what might be done to alleviate it. I am concerned that too many people are talking about letting it cure itself. The recent $4.3 billion program will only prevent some immediate hardships. The result is now predicted to be continued high rates of unemployment for much longer than any time since the Depression. As you Annual Report shows, we can expect two years in the 9% range, followed by two more in the 8% range. Then, if we are lucky, unemployment may finally reach 7.5% in 1988. At that rate, we would be lucky if we realize anything resembling "full employment" by the end of the decade.

Indeed, if it really will require 6 to 8 years to get unemployment to "full employment" levels, then I really doubt that we will achieve that goal before unemployment rises again.

I say that because the forecasts are based on 6 to 8 years of fairly steady growth, with no significant economic downturns. This would be an extraordinary economic preformance. There is nothing in the history of the past decade that would encourage us to expect such a strong economic performance. Quite the contrary.

So I am dismayed to see that no one in this Administration proposes that we take positive action to reduce unemployment. When the primary economic problem was thought to be inflation, the Administration, along with the Federal Reserve Board, took what I think might be called extraordinary actions to reduce it. And it has certainly dropped—from double digit levels to 4% in just two years.

That was accomplished at great loss to the economy—perhaps $500 billion in 1984 alone. It was done at the cost of great suffering by many millions of unemployed also. That is why I believe we owe it to the unemployed to take the same positive steps to alleviate their suffering and return them to gainful employment. Any cost involved will be small when compared with the hundreds of billions of dollars of lost economic activity that caused the unemployment.

POLICY OPTIONS TO REDUCE UNEMPLOYMENT

In this regard, the CBO's Annual Report has performed an important service by devoting a section to Policy Options to Reduce Unemployment. That section appropriately notes the relation between lowered inflation and increased unemployment when it says: "Slow growth in the economy since 1979, including two recessions, has substantially lowered inflation but raised unemployment to record postwar levels."

Your report then suggest three avenues of approach to the long term employment problems this nation faces.

Federal action to stimulate economic activity and provide direct job opportunities to the unemployed.

Actions to reduce the "structural" unemployment problems.

Temporary measures to reduce the hardships of unemployment.

I hope that we will have time to explore some of these ideas in more depth this morning. I am pleased to see you here one more time to help us grapple with these difficult problems.

Senator BIDEN. Doctor, nice to see you again. I am sorry to see you leave. I guess this is about the 10th year you have testified at the beginning of the budget process, if you count your first testimony, when you were at the Bookings Institution. I am sorry you are going to be leaving.

Dr. RIVLIN. Thank you.

Senator BIDEN. I have about half a dozen specific questions, some of which have been asked and others which have not. One of the things that comes to me as I have sat here listening to the exchanges that have taken place so far this morning is—and I am not being facetious when I say this, I am not sure, based on your analysis that there is much of anything that the Congress can do about anything right now. I am not being facetious. I am serious.

Dr. RIVLIN. I know you are not.

HIGH UNEMPLOYMENT FOR THE NEXT 5 YEARS

Senator BIDEN. And obviously, and if I could run through just for a moment and ask you to comment, rather than ask a specific question, ask you to comment on my observation.

You and everyone else is saying that unemployment for the next 5 years will be historically—by historical terms, very high. I forget the precise numbers but it goes from above 10 points down as low as—by 1988, I guess with constant economic growth, we get down to what——

Dr. RIVLIN. I think we have 7.5.

Senator BIDEN. 7.5, I beg your pardon. 7.5.

Now, I quite frankly do not know how politically that can be sustained without a cry for action on the part of the Congress, even if the Congress cannot do much constructive about it, they will certainly, if the pressure is enough, attempt to do something. It may make it worse or it may make it better. So, you have unemployment—not you—unemployment by everyone's estimate is going to be high for the next 5 years. The interest rates, although coming down, may, short term, bump up a little bit more, and we all acknowledge that we do not know what the Fed is really going to do. We can only take them at their word, and I assume that you do not think that there is much that the Congress can do about interest rates.

Is there anything that we could do?

REDUCE LONGRUN DEFICITS

Dr. RIVLIN. I think the main thing you could do is get the longrun deficits down.

Senator BIDEN. And which leads me to the third point, that is that here we are going to have unemployment at very high levels, at least by my standards and I think everyone's. Democrats and Republicans on the committee would agree that 7.5 is much higher than we would want, and that is the best--that is the figure that we are looking at 5 years out. And we realize that interest rates are a significant element in long-term recovery and consistent economic growth, and the one thing that keeps interest rates from going up would be to do something about the deficits.

Now, it seems to me the thing that guys with my political philosophy are going to be faced with over the next 5 years is if we begin to deal with the unemployment problem in terms of spending dollars to deal with the unemployment problem, whatever programmatic approach is adopted, whether it is one like the President's coming up with or other programs, or if folks like me who think we should be spending more money and not less for education, or folks like me who think we should be spending more money, not less money, on certain research and development in the energy fields, and we are constantly for the next 5 years going to be faced with the alternative that Biden, if you move in any of those areas, you are going to be increasing the deficit which everyone acknowledges, including you, that the deficit is going to be in the range—the baseline deficit for fiscal year 1988 you project is 267 billion. So obviously we are talking big numbers here.

Dr. RIVLIN. That is right.

SPENDING PRIORITIES

Senator RIEGLE. And if you take the administration's deficit is "only 183 billion."

Senator **Biden**. Are we really saying here—are the economists really telling us that for the next 4 to 5 years that the Congress should really be doing nothing in terms of spending more money on any programs at all, whether it is education or anything else? Are we saying, to put it another way, are we saying to the people, should we be saying to the people, look, the next 5 years, whether you are in agriculture, or in education, or whatever, do not expect, in real dollars, any more than is coming now? Is that what we have to say?

Dr. **Rivlin**. I think that question depends on how much you want to change the priorities in Federal spending. But, yes, I think it is realistic that unless you are willing to raise taxes a very great deal—by more than the President is suggesting and by more than has been talked about this morning—that, when you talk about spending increases for education or whatever, you will have to explain what other spending you are going to cut to get that increase. The prospect for getting the deficits down to manageable proportions does require that overall spending be cut from current levels, even with substantial tax increases.

So I think your perception is unfortunately quite correct, and it is a very difficult one. And with respect to the shortrun unemployment problem, it does leave this terrible dilemma.

In the old days, in such a situation, we used to have a more stimulative fiscal policy. Well now, you already have a more stimulative fiscal policy; so whatever you do to relieve specific problems of the unemployed—and unless you find a way of paying for it—will escalate the deficit. That makes it just very, very hard to deal with.

Senator **Biden**. I realize my time is up, Mr. Chairman, and I will not trespass any more.

Thank you very much Dr. Rivlin. We are going to miss you.

Dr. **Rivlin**. Thank you, I will miss you, too.

Chairman **Domenici**. We are going so slow at her replacement, she may be here for a while.

Senator **Biden**. In light of the economic picture that we Democrats and Republicans see out there, no wonder there is difficulty in finding someone willing to do it.

Chairman **Domenici**. Senator Exon.

Senator **Exon**. Thank you, Mr. Chairman.

Doctor Rivlin, let me add my words of welcome by my colleagues. I say once again, that I just think under your direction, the CBO has been a great deal of help to us, and if and when you leave, which I hope you will not, we are going to miss you a great deal.

Dr. **Rivlin**. Thank you.

EFFECT OF INCREASED GAS TAX ON UNEMPLOYMENT OR EMPLOYMENT

Senator **Exon**. Let me go into several questions, many of them have been asked, but maybe I can amplify, and maybe draw you out a little bit more on some of them.

First, has CBO done a study as to the effect of the increased gasoline tax on unemployment or employment? Have you done any studies as to whether we can expect a net increase in jobs as a result of that legislation the next year, and 2 or 3 years down the road? Have you gotten into that at all?

Dr. **Rivlin**. We have not done a specific study of that, although at the time the legislation was being debated, we were asked about the net job-creating effects of increasing highway spending and raising the gas tax. At the time, it was our judgment that it was approximately a wash. It is good to get the roads fixed, but it could not be counted as a net increase in employment.

Senator **Exon**. Thank you.

PIK PROGRAM

It seems to me that CBO has basically endorsed the figures put out by the administration with regard to the PIK program.

My question is, have you done any studies on the other important side of that, as to what this program will do next year, and if extended a second year, which is not talked about very much, but which is necessary if the program is going to be workable, what effect that new approach will have on the world on the whole, the mainstream, fertilizers, jobs, so on and so forth? Have you done any studies on that?

Dr. **Rivlin**. No, we have not. We would be happy to look into that, and to talk to you about it further. We do have some differences with the administration on the effects on the budget.

Senator **Exon**. Everybody is delighted with that so far. I hope the program works.

Dr. **Rivlin**. I hope so, too.

ECONOMY TOLERATES $200 BILLION-RANGE DEFICIT IN 1984

Senator **Exon**. Let me get back to the deficit question.

We hear stories, and the big story is that the economy of the United States tolerates $200 billion-range deficit in 1984, but cannot under the outyears. That confounds me a little bit.

How can we tolerate it in 1984, but not in the outyears? Do you agree with that theory?

Dr. **Rivlin**. Yes, I do. Not that I think that $200 billion deficit in 1983 is a terrific thing. But I think it is tolerable, and to some extent, may be desirable in a period in which we have a very deep recession, a great deal of slack in the economy, and little prospect for private borrowing at high magnitudes to finance investment expansion.

However, the reason that it is such a problem in the outyears is that we are assuming, that the economy will pick up. That means private credit demands will pick up substantially to finance new plants and equipment in the years down the road. And at that moment, Federal deficits will become much more competitive than they are now with the private sector; that is what puts upward pressure on the interest rates.

DOWNTURN IN INTEREST RATES

Senator **Exon**. Following up on that, then, in what Senator Riegle was trying to get to, I believe, we traditionally tie the interest rates in with inflation.

I am wondering if we are not going into some new economics—and I am beginning to wonder if the downturn in interest rates were not a combination of the recession and the lessening demand for money in the private sector. Which do you think is the most important of those two factors? Are they equal? Does one outweigh the other?

Dr. RIVLIN. I think the downturn in interest rates was definitely reflected—though it is hard to say how much—in a lessening of private credit demands and the general weakness in the economy, as well as an easing of Federal Reserve policy.

OUTYEAR DEFICITS MAKING RECOVERY UNSUSTAINABLE

Senator EXON. Well, given that, and given the deficits that you are projecting in the outyears, how can you think things are going to be better, that is my question?

Dr. RIVLIN. Unless the deficits in the outyears are gotten down, I do not think they will be better on a sustained basis. I think much depends on what the Congress, under the leadership of this committee, does.

If the recovery is to be sustainable, I do think you have to get the outyear deficits down. If you do not, I do not think our projection for the outyears will materialize.

Senator EXON. But are you not projecting—there were headlines all across the country that CBO generally is more pessimistic than the administration, has come out with a forecast that is rosier than the administration's.

Dr. RIVLIN. In the near term.

Senator EXON. In the near term. And yet your deficits are higher than the administration's, is that right?

Dr. RIVLIN. No; our deficits—if you are talking about current policy deficits, what would happen if you do not change the laws—are somewhat lower than the administration's in the near term, for the same reason: because we have a slightly more optimistic growth rate, we have slightly lower deficits. But I think the differences are not large, either in the deficit estimate or in the economic forecast Everybody sees roughly the same picture: namely, the danger of those looming outyear deficits making the recovery unsustainable.

POSSIBILITY OF SERIOUS INTERNATIONAL IMPLICATIONS

Senator EXON. Mr. Chairman, I know my time is up. Just one last question. I think I can get a quick response from Dr. Rivlin on it.

In your projections in the future, in the near term, and in the outyear term, I assume that you have not taken into consideration any possibility of serious international implications in the money market, substantial bankruptcies by other countries, partial or total breakdown in the International Monetary Funds. I assume you have not taken that possibility into consideration.

Dr. RIVLIN. That is correct. We assume that that will not happen.

Senator EXON. Thank you, Mr. Chairman.

Thank you, Dr. Rivlin.

Chairman DOMENICI. Senator Grassley?

COST GROWTH IN WEAPONS SYSTEMS

Senator **Grassley**. Thank you, Mr. Chairman, and Dr. Rivlin, I was not able to hear your opening statement, because I was caught in a long line of traffic, probably like everyone else who is not here this morning.

I would like to continue, to visit with you about the defense budget, and I would like to specifically refer to a document that came out of your office on October 1982, "Cost Growth in Weapons Systems, Recent Experiences and Possible Remedies."

Your Budget Office has put together this study, and it analyzes rising costs of defense weapons. This study points to serious underfunding problems. And in your view, how bad is this problem?

Dr. **Rivlin**. Well, it depends on how one assesses the success of current efforts within the Defense Department to get control of the longrun cost growth problem.

Senator **Grassley**. I want to touch on that, too, in some followup questions, but go ahead.

Dr. **Rivlin**. As I said earlier, one thing that is apparent from our examination so far of the new defense budget is that it does not do what some past budgets have done—namely, seriously underfund the programs with respect to inflation. They do seem to be fully funded with respect to what we anticipate in the way of inflation, at least for the next few years.

However, the Defense Department does not allow for real growth over current estimates in procurement costs. If that happens, as it has in the past, it could add substantially to the costs of the currently projected procurement. A real growth rate of 3.5 percent over time would add some substantial sum—I think, $69 billion accumulated over 1984-88.

CARLUCCI INITIATIVES

Senator **Grassley**. Well, following up on that then, I would like to refer to what are referred to as the Carlucci initiatives. These were supposedly designed to bring about management efficiency within the Pentagon, and of course, even the people in the Pentagon, including Secretary Weinberger, have admitted that there have been terrible underfunding problems in the past, but they are taking the position, and so this is what I want to ask you about, that these Carlucci initiatives have corrected the problem.

(*a*) Has the problem gone away, and (*b*) can CBO validate the savings from the Carlucci initiatives?

Dr. **Rivlin**. Unfortunately, I think it is too soon to give any kind of quantitative estimate. We do, as we examine this year's Defense budget, see some signs of improvement, but there are still substantial evidence of cost growth over last year. At the moment, it is too soon for us to say exactly what the Carlucci initiatives have done. I do not think that anyone in the Defense Department would say that the problem has gone away.

Senator **Grassley**. Well, then let me ask the question from this standpoint. Based upon your long and great experience at CBO, do you think it is possible, or will be possible to validate the impact of the Carlucci initiatives, one way or the other, or is it a nebulous sort of handle that we are trying to place on it?

Dr. Rivlin. It is very nebulous, and evaluating the impact of a particular procedure change is very difficult, because you do not know what would have happened without it.

However, in a couple of years—and I hate to advise waiting that long—one can look at whether cost growth has slowed down below what it has been historically. Then, you can judge whether you are getting essentially more accurate and more honest estimates of what the systems will actually cost.

I think, as I said, the progress on fully reflecting likely inflation is considerable. The progress on changing the incentives within the Department, and within the contracting community, is very hard to assess. I hope there will be some way of assessing it eventually, but there isn't one now.

HANDLING COST OVERRUNS AND UNDERFUNDING

Senator Grassley. Well, assuming that it is too early to analyze the Carlucci initiatives, again, based upon your considerable experience in Government budgeting, and let us assume that they were going to take hold and account for something, how long, from your budgeting experience, would it take to get a handle on this problem of cost overruns and underfunding?

Dr. Rivlin. I think it would probably take a year or so to figure out how well you are doing, but it is not a problem that you are ever really going to get entirely on top of. I think it just has to be pushed on and pushed on and pushed on.

I would be glad to give you a fuller answer to this question for the record, or perhaps we could discuss it as well.

[The following was subsequently supplied for the record:]

We are just beginning to acquire information reflecting on the Carlucci initiatives, from such sources as the Congressional Data Sheets and the Selected Aquisition Reports (SARs). A few years from now, as we accumulate and analyze this information, we should be able to judge the success of the initiatives by comparing rates of growth in future SARs to those in the past. Judgments during the next year or two will, however, be highly conjectural. Some of the initiatives, such as multiyear contracting and more economical production rates, will increase costs up front but may achieve substantial savings over the life of a program. Such savings are naturally difficult to estimate now.

Moreover, even after several years it may be difficult to know whether the Carlucci initiatives were indeed the cause of any slowing of cost growth. The SAR data, which provide the principal source of information on weapons costs, do not allow clear separation of cost changes by fundamental causes. Since costs are affected by many factors, it will be difficult to isolate the effects of the Carlucci initiatives.

Senator Grassley. On a relative scale, how do the Carlucci initiatives compare to other attempts, in the period of time that you have been connected with Government budgeting, to get what is imbedded in the bureaucracy for the last 30 years, this problem?

Are these--do these initiatives have greater prospects than any known of in the past, on a relative scale?

Dr. Rivlin. I hope so. There certainly is very serious effort to——

Senator Grassley. You hope so. Do you have a feeling that they are going to?

Dr. Rivlin. I do not have a basis for assessing that, yet. They are not the first attempt on the part of the Defense Department——

Senator Grassley. Are they better than any of those other attempts?

Dr. RIVLIN. They are probably more comprehensive.

UNDERFUNDING IN OTHER PARTS OF THE BUDGET

Senator GRASSLEY. More comprehensive. To what extent is underfunding a problem in non-Defense spending, the rest of the budget?

Dr. RIVLIN. It is also a problem. There have been studies—Rand did a study, and so did the General Accounting Office—of underfunding in other parts of the budget, and it is a similar kind of phenomenon. It is frequent that the agency involved underestimates the cost of a program it undertakes.

Senator GRASSLEY. The positive contribution then of this administration to that problem, and as it relates to Defense then, is that they have at least locked in an honest analysis and projection of inflation, is that right?

Dr. RIVLIN. Yes, there has been definite progress.

Senator GRASSLEY. But beyond that, it is impossible to document very many dramatic changes with the problem of underfunding?

Dr. RIVLIN. I think that is right.

Senator GRASSLEY. Thank you, Mr. Chairman.

HIGH GROWTH PATH VERSUS LOW GROWTH PATH

Chairman DOMENICI. Doctor Rivlin, I am somewhat confused today by your testimony.

I, too, apologize for being late. I was in the traffic jam, and then had to go to the White House for a little while.

What basically accounts for a high growth path versus a low growth path, as you give us in your assumptions? What are the big things that are different between high growth and a low growth?

I am looking at your alternative projections for economic recovery.

Dr. RIVLIN. Yes.

Chairman DOMENICI. I think I have looked at them all, but I think I would choose a high growth path in every instance, you say that is what we would want. What is the significant difference by way of policy decisions between the two?

Dr. RIVLIN. I think that there is much to be said for aiming for a higher growth path than the economy now appears to be on. But if one is concerned about the future escalation of inflation, there are risks to be taken into account.

MONETARY POLICY CAN ACCELERATE GROWTH

Chairman DOMENICI. Well, I know that, but I looked with amazement, and found that even under your high growth path, we have some rather significantly low inflation rates even in 1988.

So I am wondering—what does the U.S. Government, through its policymakers do to give us the high growth path? How do we face all the risks, and still keep inflation down as low as your high growth path says? Is that all a question of monetary policy?

Dr. RIVLIN. I think a lot of it is a question of monetary policy, and it is a very uncertain world in which to discuss monetary policy. I think if you are talking about how do we insure that we are on a higher growth, rather than a lower growth path, the answer has to lie in the monetary world. As we said earlier, and as Senator Biden brought out, it is very hard to use fiscal policy to stimulate the economy right now, because it is already so stimulative, and we are worried about the outyear deficits.

So if you are king and pulling the levers, the lever to pull to accelerate growth is presumably monetary policy. But an easier monetary policy that would give you high growth in the short run does carry two risks. One is that, if monetary growth rates are very high, you might get higher real growth in the economy in the short run, but you might not, because this might signal to the financial community concern about future inflation, and you might actually get higher long-term interest rates, which is a no-win situation.

And even if you did not get higher interest rates in the short run, there are certainly those who would be concerned that you would get them in the long run, and more inflation with a high rate of monetary growth. Those are the risks to be weighed, and I do not know exactly how to weigh them, but those are the considerations that go with getting on to a high-growth path.

HIGH AND LOW GROWTH PATHS SHOW LARGE DEFICITS

Chairman DOMENICI. You have both of your growth paths high and low, take effect with extremely large deficits in the 1985–88 timeframe. Is that too risky, or are you saying it can be done with deficits that high?

Dr. RIVLIN. We are not saying it can be done. The reason for running out those alternative growth paths is to illustrate that, even with the high growth, you have very high deficits. We are not saying—and I have made this explicit—that the sustained growth at either a high or moderate level is necessarily consistent with those high outyear deficits. I do not think it is.

Chairman DOMENICI. Now, everyone has forecast very high deficits in 1984, under almost any policy. I take it that that is not one of the big risks when looking at the next 5 years in terms of a sustained recovery, am I correct?

Dr. RIVLIN. Yes, I am not so worried about 1984 as I am about 1985 and beyond.

Chairman DOMENICI. Then is it fair to say that the challenge to the Congress, and to the extent that this committee can influence it, is that that we have to put in place something credible, reliable, that reduces the outyear deficits, we have to do it now, in the 1984 budget cycle, is that what you are telling us?

Dr. RIVLIN. Exactly. That is how I see your problem, and it is a very difficult one.

Chairman DOMENICI. So we are confronted with trying to put into effect some kind of a wedge policy in terms of savings over current policy. The savings are not necessarily so large in 1984, but they must be wedged so that they get rather large in 1985–88, is that correct?

Dr. RIVLIN. That is right.

JOBS PROGRAM

Chairman DOMENICI. Let's talk about some current subject matter, the the so-called jobs program. What is a jobs program?

Dr. RIVLIN. Well, it means different things to different people. In general, I think it means spending additional money on programs that will put people to work directly, either on repairing Government buildings or in other kinds of direct employment.

Chairman DOMENICI. What is the best jobs program for the United States?

Dr. RIVLIN. Clearly, the best major jobs program is to get the economy moving again. We have 12 million people unemployed, and the kinds of direct Federal employment programs, or even State and local government programs that are being talked about, would not make a large dent in that unemployment. The way to move the unemployment rate down is to get economic growth up.

TARGET JOB CREATION PROGRAMS

Chairman DOMENICI. Senators like Senator Riegle is from a State with extremely high unemployment, where employment losses came principally from the heavy industrial centers. Are you aware of any jobs program of a type you described specifically as contrasted with general economic recovery? Are you aware of any jobs program that would have major ameliorating effects on heavy industries, high unemployment, and the pockets and States that have highest unemployment?

Dr. RIVLIN. Not directly, but there have certainly been proposals to target job creation programs to States where the unemployment is unusually high.

Chairman DOMENICI. If you target them, would they put people back to work doing what they had been doing in the past, or would they put them back to work in doing something else?

Dr. RIVLIN. Well, it depends on what you do. I do not think the Government can open a steel mill.

Chairman DOMENICI. Or an automobile plant.

Dr. RIVLIN. Or an automobile plant. But the need for heavy industry isn't zero. Steel has uses in construction, for instance, so a major construction program, or a roadbuilding program, particularly bridges, would have some heavy industry components. But most of the programs we talked about are programs to alleviate the distress of the unemployed, to get people back to work doing something, and rather than back to heavy industrial jobs themselves.

Chairman DOMENICI. Even when we get back to having only structural unemployment left in this country, or frictional unemployment, as we used to call it, will there be significantly less jobs of the type that were in steel and autos and related fields than there were before, in your opinion?

Dr. RIVLIN. Probably, though it depends on exactly what range of industries you are talking about. Certainly, with respect to automobiles—as the industry itself has acknowledged—the problem is modernization and automation, in order to compete better in the international market. But that implies fewer jobs per car built.

SUSTAINING RECOVERY IN THE OUTYEARS

Chairman DOMENICI. Just two last questions.

If the economy recovers as well as you predicted in the short-term, do you believe that the chance of it being sustained in the outyears, 1985, 1986, 1987 and 1988, is dependent significantly on fiscal policy, as contrasted with the earlier years?

Dr. RIVLIN. Yes, I believe that you increase the chances of sustaining the recovery greatly by getting the outyear deficits down. That is where fiscal policies made now have their major role.

Chairman DOMENICI. If there are some euphoric attitudes around because recovery is occurring, one of the risks is that we would not do what we ought to do with reference to the 1985, 1986, 1987 and 1988 budgets. If we don't send the right message now, about how that will look in the future?

Dr. RIVLIN. That is right, and if the economy does take off in the near term—faster than most of us are expecting—that does mean that the collision between Federal borrowing and private borrowing is likely to come sooner rather than later. It increases the necessity of doing something about the structural deficit.

Chairman DOMENICI. So for those who think it all could be done with monetary policy, you recognize the prospects for a collision in the outyears, and that monetary policy will not accomplish the entire recovery, is that correct?

Dr. RIVLIN. That is correct. We have stressed very heavily the problem of the outyear deficits.

CURRENT MONETARY POLICY OF THE FEDERAL RESERVE

Chairman DOMENICI. How do you categorize the current monetary policy of the Federal Reserve? What is it now, and what should it be for the next 24 months?

Dr. RIVLIN. I would say it is in transition. But we are assuming—and we will learn more from Chairman Volcker this week—that it is the intention of the Federal Reserve to aim its policy toward sustained, moderate recovery. That is really what they have said and what seems to be a desirable policy. Exactly what instruments they use to do that remains to be seen. But I would characterize the current monetary policy as feeling its way, but as moderately accommodating.

REDUCE OUTYEAR DEFICITS TO HELP CONTROL INFLATION

Chairman DOMENICI. What has changed, that permits you to be optimistic that the real interest rates will come down to more of their normal historic disparity between inflation, using inflation as a measurement against interest rates? Right now, they are the highest in history, and have remained that way in spite of declining inflation. What has to change to cause them to get more back into the historic pattern?

Dr. RIVLIN. Well, I think there has to be a realization that inflation really is coming down, and there has to be more certainty that the Federal Government's deficit will be coming down in the future.

Chairman DOMENICI. Assuming——

Dr. Rivlin. It is probably both of those things.

Chairman Domenici. Assuming that we produce a credible plan for reduction of deficits in the outyears, you have always told us, and all economists have always told us, that there are many things that impact on inflation.

Are those other things more under control coming out of this recession than past recessions? Would that give you enough hope to say that the principal thing we must do is insure lower deficits, and then inflation will remain somewhat under control?

Dr. Rivlin. That is the way it looks now. There are always enormous uncertainties. We could have another oil embargo, or war in the Middle East, or a terrible crop year. Various other things that—all unpredictable—could change the picture.

But as the situation looks to us now, inflation is likely to continue to come down some. The softening of the oil market is contributing, as is the agricultural situation, and the general slackness of the economy. The main thing that the Congress can do to insure that is to get the out-year deficits down, and I come back to the same song.

EFFECT OF $5 BILLION JOBS BILL ON UNEMPLOYMENT

Chairman Domenici. Some are talking about a $5 billion jobs bill, not in the macro-sense. I think the numbers tell me that the change in unemployment that occurred in the last batch of statistics would have cost about $4.2 billion, if you could have targeted and put everyone who wanted to work on the rolls. I am not sure that is right, but that is the kind of number I get.

How much good will a $5 billion jobs bill do in terms of unemployment?

Dr. Rivlin. Well, we could give you a calculation on jobs created, depending on how you spend money. It will not be an enormous proportion of the 12 million now unemployed. Job creation programs have varying efficacy in putting people to work. If you emphasize high-skill employment, you do not get as many people. If you emphasize low skill, you get more jobs.

Chairman Domenici. I am not arguing that we should not do some, and I am not arguing at all that there are not some situations in the country where we really have to do some things to help people who really need help. But I guess my question is directed at the concern that continues to be expressed in our committee about the longevity of high unemployment in many forecaster's projections.

I guess I am directing my attention at that $5, or $7 or $8 billion jobs bill added annually into these programs. Will it have a significant effect of bringing that high unemployment number, that residual unemployment?

Dr. Rivlin. No, but it will help some people and probably get something useful done.

Chairman Domenici. I understand that, and in that respect, as long as we understand that, I am not expressing pro or con. I am just looking at the 9.6 percent residual unemployment, or the 8.8 percent. That will only be overcome when the economy is growing, and growing at a consistent rate.

Dr. RIVLIN. And for a long time.

Chairman DOMENICI. And for a long time. And it will be altered depending on how fast things grow. Under a high growth path, with low inflation, the unemployment should be down substantially over the alternate of low growth, with the same inflation, is that correct?

Dr. RIVLIN. That is correct.

GROWTH ITEMS CAUSE OUTYEAR PROBLEMS

Chairman DOMENICI. In terms of past testimony, you have told us that the long-term problem with the budget deficit stems from entitlements. I assume, that even with the social security fix that the blue-ribbon commission recommends your testimony would still be that the entitlement programs and not the means-tested programs are the ones that cause the outyear problems, plus defense?

Dr. RIVLIN. Plus defense, that is right. The growth items in the budget are defense, social security, even after the commission's recommendation, medicare—very rapidly growing program—and interest.

Chairman DOMENICI. And the two Federal pensions?

Dr. RIVLIN. Right.

Chairman DOMENICI. Did you want to try one more round?

Senator RIEGLE. Yes, please.

Chairman DOMENICI. I have only a few more minutes. I will accommodate. I am 35 minutes late for the chairman's meeting, but I will be glad to.

FURTHER EASING OF MONETARY POLICY EXPECTED

Senator RIEGLE. It seems to me, Dr. Rivlin, that we have covered some important ground today in terms of what it takes to get a recovery going and keep it going. I want to come back to your assumption on interest rates because we do not—if we do not get the lower pattern of interest rates, we are not going to see much of a recovery, I think we are certainly—not a sustained recovery here. And it seems to me that that, too, is the thrust of your remarks.

Earlier, you indicated, and I will not read back the transcript, that you expect that in the short run the Fed by other statements that it has made will do what it can to try to get a recovery going here and that suggestion is that it is somewhat easier monetary policy beyond what we now have. In other words, that we will see some further easing but until we hear from Chairman Volcker this week before the Senate Banking Committee, we do not know necessarily what they have in mind. But I gather that is what they—what one can infer that from what you said, both directly and from the thrust that we have been saying back and forth.

Dr. RIVLIN. Yes. If one assumes that interest rates are an appropriate gage of monetary policy—and I think it often is useful to do so—then our projections of lower rates are indications of a more accommodative monetary policy.

CONSENSUS IN CONGRESS TO LOWER DEFICITS

Senator RIEGLE. Well now, first, here is the bind that I think we are in. I think there is a consensus in Congress that your deficits have to come down and that you have got to cut lots of things to do that. You have to cut the defense increases, you have to find some additional savings in the nondefense area and you have got to do something on the revenue side, maybe indexing or what have you, by both revenue and spending cuts, to bring those deficits down. And that eases the outyear problem and that feeds back into expectations of the financial markets and so forth.

The problem is that even if there is a consensus along that line in the Congress, the President is still quite vigorously arguing for his full defense increase. In fact, the news last night is to the effect that the White House is about to undertake a major public relations campaign to support their defense increase and that is one critical part of this puzzle. And accompanied by, I noticed, a full-page ad in the paper today which I assume is part of what will be this public relations campaign on behalf of defense spending.

So we have this problem still where there is a growing consensus here in the Congress, it runs head on into what seems to be the latest thinking in the White House, at least with respect to the defense increase, and that is a major part of this puzzle. And if we do not get that piece into the puzzle, I doubt that we will get the rest.

Now, to that has to be added the fact that we are still some months away before we are going to have the binding second budget resolution. This is not something that is going to be worked into place soon. I wish that were not the case but that is the case. That is just the normal process by which things work.

Dr. RIVLIN. That is right, but you might do what you did last year, and write the first resolution so that it really was the second.

Senator RIEGLE. Yes; but I would be quite surprised if that were to happen. I mean I would think the shift of players in the House of Representatives alone probably forestalls that as a possibility. I would think it would be more apt to go in the orderly fashion, the first resolution nonbinding and the second resolution more fine tuned down the line. Who is to say? Time will tell. But my hunch would be that it would be more apt to be along that line.

So that—if that is the case, that brings us even more back on short-term monetary policy. Because if we are going to get things going here, we are going to have to have interest rates lower than they are now to hit either your projected target for the year or from what others in the homebuilding industry and automobile industry tell us were needed. I must just tell you, I do not know how closely you are following events; I assume as closely as anybody in the last 2 or 3 weeks. There is softness in housing right now despite the recent uptake. I had the head of the National Association of Homebuilders in my office this morning expressing apprehension about this recent uptake in interest rates over the last 2 weeks which sent a chill through the housing sector. I can tell you in the auto sector that the sales that we have had in relationship to the housing special financing incentive that has been offered to the low market rates have been helpful but set off no great boom. We have not had large numbers of people call back. Roger Smith was quoted in the paper, the head of General Motors was quoted as saying a 10-percent increase over a disastrous year is still a disastrous year in the making.

So we all want to be optimistic here but it seems to me that there is not an awful lot right at the moment to put our hands on and that undergirds the notion that we are going to get a surge here and carry us through the rest of the year and hopefully beyond.

KEY SECTORS OF STRENGTH

One of the items right now, as you look into taking into account the events in the last 2 weeks, 3 weeks, the last 2 months, trend lines and so forth, I would like you to summarize if you would, just quickly, the key items of new strength that you see that really give you the basis for optimism; and also then what you see as the items of greatest concern, because you have been very careful to say that everything sort of has to fit together here if we are going to get recovery. But I would like to know what are the two or three things, the recent signs that give you the greatest sense of optimism and what are the two or three things on the other side of the scale that give you your greatest apprehension right now in terms of whether or not we are going to see this recovery take hold?

Dr. RIVLIN. Well, I share your concern about all of these things, but I do think the one strong sector is housing on a lot of different measures; the numbers have not been entirely consistent, though, and it is very hard to interpret them in the winter. But still, housing does seem to be appreciably stronger than it was 1 year ago. Automobiles are also a sector of strength. The automobile companies do seem to be assuming that we are going to have higher sales later in the year, and the actions they are taking are consistent with that. I hope that they are right. The consumer sector generally looks to be primed for an increase. The conditions are reasonably good, though the recent retail sales numbers are not very exciting. In general those are the main areas of strength besides defense spending, which is also a source of strength in part of the economy.

NEGATIVE SECTORS

The negatives include the business investment which is still very low. The export sector is still suffering from weak economies abroad and from the fact that nobody is buying; it is also suffering from the high value of the dollar which we expect will come down, but which is a problem right now.

GLUM MOOD

Senator RIEGLE. Well, if interest rates do not come down further it is hard to see how the dollar comes down.

I do not know if you have seen the piece in the front of the Wall Street Journal today. I will just read you the headlines from it. It is one of their feature stories. It is called Glum Mood.

> Despite recovery talk, people don't indicate any shift to optimism. Wall Street Journal survey finds steep joblessness, Reagonomics stirs dismay.

It is a long piece to the effect that despite there is a boomlet in town right now to the effect that, you know, we are on the mend, the economy is rising, Feldstein is shifting his notion of better prospects coming and so forth. But you know, when I look at—when I reach through into those auto numbers and I take a look at what the advanced manufacturing schedules are in which people are being called back, there is not an awful lot there and I urge you to take a look at it because perhaps I am wrong, but I am afraid I am not wrong.

INTEREST RATE ASSUMPTION LACKS SUPPORT

On the housing side as well, apparently when we get into this 12-, 13-percent interest-rate range and there is a question of where it breaks, some say 13, that was the consensus of opinion yesterday in the Housing Oversight Banking Committee, that if mortgage rates on new housing starts, new housing purchases are 13 or higher, I mean the curve really sort of falls off quickly.

So, I guess what I am saying to you is that your interest-rate assumption, I think, is really the linchpin to this whole thing. I am just concerned right now that we do not have enough to support that and I am not sure it is right. And if it is not right, then we could well find ourselves in a worse problem quickly here than we imagine, with all these outside events which you were pointing out to Senator Exon, we do not anticipate a financial crisis abroad, God forbid that one should happen. But I must just say to you, you know, we have been in negotiations, urgent negotiations with Mexico now over a period of several days and weeks, and it was anticipated that we were going to have an agreement. Well, each day comes and goes and there is no agreement. Their needs are accelerating.

So, I find myself very uneasy about hanging my hat on the forecast that we have now, to share that with you for what it is worth. I want to be optimistic but I do not see much basis for it right at the moment that is concrete and tangible.

Dr. RIVLIN. I appreciate that, and I agree that it is a very uncertain situation.

Senator RIEGLE. I might just say finally I think you have done an extraordinary job in this assignment and I think you have been a breakthrough in many ways in terms of holding this position and doing it in a distinguished fashion. Whoever comes along next is going to have a very tough time of following and measuring up to the accomplishments that you demonstrated and I just take great pride as I think the whole committee does in the fine work that you have done.

Dr. RIVLIN. Thank you very much. I appreciate that.

WHOLESALE PRICES DECLINING

Senator EXON [presiding]. We are going to close this down in just a moment, Dr. Rivlin. I have two questions. Hopefully no one else will come in so that we can close it down.

We Democrats hang around because we do not get to chair a committee hearing any more. At the end when we force the Chairman out, why we get to take over.

Two quick questions.

There was universal delight last week with the announcement that the wholesale price index was down a full 1 percent, I believe, the largest decline in a month since you have kept records on this. And now certainly that is something good for optimism as far as inflation is concerned. But is there a possibility that a significant drop like that, precipitous one might have a bad connotation in that it is a deflation. And I was a youngster, but I remember deflation was one of the things that we worried most about during the Great Depression era. As an economist, try to put that into the context that a layman like myself can understand. Are we always overjoyed when prices go down that much, especially at a time when we would like to get things going again? Is it a foregone conclusion that since prices go down at the wholesale level that people are going to buy more?

Dr. RIVLIN. No; but, of course, whether you are overjoyed or not depends on whether you are buying or selling. But in general, inflation has been such a problem for our economy recently that I think it is good news when it is clear that it is mitigating. There are problems of adjusting to deflation as well, though.

If you are a seller, it is not always good.

Senator EXON. Are people buying more gasoline because the price went down or are they buying the same or less?

Dr. RIVLIN. In gallons, I think they are probably buying somewhat more, although I do not know exactly what the numbers are.

CONCERN OVER HIGH TECHNOLOGY

Senator EXON. Well, my last question has to do with the perception that I keep hearing about and I think people in your profession, your economists keep talking about it, the President made a statement in the last 10 days, he said that many of the jobs that people left are gone because we do not have those jobs to go back to. And more and more, we hear about, we have to turn to high technology. I guess that means everybody is going to be punching a computer and looking at a screen. It seems to me that a major country like ours, if we are going to concentrate on high technology, it seems to me that we are going to pay less and less attention to some of our basic industries such as the automobile industry, the steel industry, maybe we could even consider agriculture in that area.

Do you have any concern as an economist, do we think so far of our high technology that we may be leading this Nation down the path that we might not want to go too far on and that is that we are not going to have any steel mills?

Dr. RIVLIN. Yes; I do have some concern about that. But I think we are not going to end up with no steel industry or no car industry. The desirable thing would be to have a modernized steel and car industry, which, while perhaps not employing as many people as it did a few years ago, was well equipped to compete in international markets. This is especially so of automobiles. In a sense, this is what has happened in agriculture; agriculture has gotten more and more efficient.

Senator EXON. And going broker and broker.

Dr. RIVLIN. And going broker in the process. But we do have an extraordinarily efficient agriculture. It employs fewer people than it did a few years ago, and that has caused enormous adjustments. No one is more familiar than you with adjusting to that.

But I think the main thing is to make those adjustments over time as easy as possible. Clearly, we are not going to end up with everybody making or running computers, nor should we. Much of the growth in jobs in this country has not been in that kind of thing anyway. It has been in services and quite ordinary ones: drycleaners, restaurants; as employers, all sorts of things have grown. But I think it is all part of an ongoing process of change that goes on all over the world. It seems particularly difficult now, because we are in such a deep recession and because we are feeling the effects worse than we would have if the general economy were doing better.

Senator EXON. Dr. Rivlin, I thank you very much for your patience. We are delighted to have you again.

This committee meeting is adjourned.

Dr. RIVLIN. Thank you.

[Whereupon, at 12:24 p.m., the committee recessed, to reconvene subject to the call of the Chair.]

ECONOMICS

WEDNESDAY, FEBRUARY 16, 1983

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met at 10:10 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Hatch, Grassley, Kasten, Quayle, Gorton, Chiles, Biden, Johnston, Metzenbaum, and Exon.

Staff present: Stephen Bell, staff director; Gail Fosler, chief economist; Richard N. Brandon, minority staff director; and Kemble Stokes, chief economist for the minority.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman DOMENICI. The hearing will please come to order.

Mr. Secretary, we welcome you to the Budget Committee. I, personally, want to commend you for your part in developing the President's fiscal year 1984 budget request. In my opinion, it is based on realistic economic assumptions. It faces up to the structural deficit problem, and it contains many sound policy proposals.

In its broad outline, the President's fiscal year 1984 budget, will serve as a useful reference point for this committee as we formulate a budget resolution. The President's budget calls for $558 billion of deficit reduction over the next 5 years, $324 billion in reduced spending and $235 billion in increased revenues. These are large undertakings. It will require the combined efforts of everyone in Congress and the administration to achieve the budget goals the President has set.

INTEREST RATES ARE RISING

I must tell you, Mr. Secretary, I am deeply concerned about the recent performance of both long- and short-term interest rates and the implications of these rates for economic recovery. The interest rate on 30-year Treasury bonds now stands more than half a point above its 10½-percent low, last January 7. The 90-day Treasury bill is now 8.3 percent compared to its 7.4 percent low of October 22. The economic recovery is barely underway, Mr. Secretary, and interest rates are rising.

Moreover, the rates that most Americans pay on their homes and cars or small businesses are much higher than Treasury rates and have declined very little. The spread between those rates and the inflation rate is incredibly wide. We must wonder whether we will get a sustained consumer-led recovery without significant lowering of consumer loan rates.

The message is clear. The Congress must reduce future deficits if the Fed is to continue a growth-oriented monetary policy, interest rates are to continue coming down, and we are to put America back to work.

The President's recognition that taxes may well have to be part of our deficit solution is a crucial first step. Financial markets must see a Federal fiscal policy which shows without a doubt that deficits will be reduced steadily and produce balance by the end of the eighties.

I am encouraged that we all appear to agree on goals. I think the next step is to reach agreement on specifics. I, for one, have real misgivings about the President's proposal for an oil excise tax. I agree that we must act to prevent temporary price reductions from reducing our conservation efforts and our drive to develop energy resources at home. But, I see an oil import fee as a better means of achieving these goals.

Despite disagreements of this sort, I am convinced that we have a chance for real, bipartisan compromise on tax issues. Congressman Dan Rostenkowski, chairman of the House Ways and Means Committee, has proposed a freeze on tax reductions which would occur after the end of this year. Even though I have reservations about parts of his plan, I applaud Mr. Rostenkowski's courage in stepping forward in the spirit of compromise and bipartisanship to shoulder part of the burden of reducing unacceptably high deficits. Mr. Secretary, it is my hope that we can all join in this spirit this year to adopt the hard deficit reduction measures necessary to assure economic recovery.

I was talking with some people yesterday about the recovery and I had a very interesting observation. You can tell the recovery has started because now we are talking about all kinds of new stimuli and jobs creations endeavors. That seems to be the history of the way we do it.

With that I will have some questions, but I want to yield to Senator Chiles and then we will get on with individual Senators, questions.

Chairman DOMENICI. Senator Chiles

OPENING STATEMENT OF SENATOR CHILES

Senator CHILES. Mr. Chairman, I have a prepared statement. I will ask that that be submitted for the record so that we will have time to question.

A couple of things have jumped out at me in the Secretary's statement.

One is your statement that we are not fully out of the inflationary woods and the other is that we cannot afford to direct monetary and fiscal policy toward excessively rapid economic expansion.

It seems like to me, if there is anything this administration has said over and over in the last weeks and months is that inflation has been whipped. Now it looks in your statement like you are saying it is not that we could not have a more vigorous recovery, it is that we do not want to have a more vigorous recovery.

I would like to know whether we have just decided that we are going to keep this high unemployment going for awhile? Aren't we going to try to wind it down? You know, it is one thing to say that we want it to be a long and lasting recovery. It is another thing when we have the suffering out there that we have now, to say that we are still fighting the battle of inflation. That concerns me. The other concern I have primarily is where we are saying that the tax cut we had was probably not sufficient. I look at your charts and see that that tax cut carries down to 17.5 percent—this is your chart—of GNP going for taxes, and since that time, of course, we have had to make one midcourse direction last year. That midcourse direction seemed to be the key to turn the markets around. When interest rates started going down for the first time, which was sort of due to the Fed's move, I believe that the additional $90 to $100 billion in taxes that we got, and now when we are looking at the structural deficit, that is 3½ to 4 percent of GNP, much of which is because we have destroyed our revenue base, to see your in statement that the tax cut was not big enough. Well, that is offense, and I guess the best way to posture yourself against any increase is to be on the offense. That is my wife's theory. Always take the offense.

But I say that you take it very boldly when you talk about the original tax cut not being figured.

Thank you, Mr. Chairman.

PREPARED STATEMENT
OF
SENATOR LAWTON CHILES

RANKING MEMBER
SENATE BUDGET COMMITTEE

SECRETARY DONALD REGAN
HEARING
FIRST CONCURRENT BUDGET RESOLUTION
FY 1984

FEBRUARY 16, 1983

THANK YOU FOR JOINING US TODAY, SECRETARY REGAN.

MORE THAN MOST IN THIS ADMINISTRATION, YOU'VE LET A SMILE BE YOUR UMBRELLA DURING THE RAINY DAYS OF THE PRESIDENT'S ECONOMIC POLICY. BUT AS I LOOK AHEAD IN YOUR BUDGET, I SEE A WAVE OF DEFICITS THAT MAY FORCE YOU TO TRADE YOUR UMBRELLA FOR AN ARK.

AT LEAST I AM ENCOURAGED TO SEE THE PRESIDENT LAUNCHING A FEW DOVES IN SEARCH OF SOLID GROUND. HE'S FINALLY TALKING ABOUT SOME RESTRAINT IN DEFENSE, SOME ADJUSTMENT IN TAXES, EXPRESSING SOME CONCERN ABOUT STRUCTURAL DEFICITS.

BUT WE ARE GOING TO HAVE TO DO MORE THAN TALK DURING THE NEXT FEW WEEKS IF WE ARE TO BE TRULY REALISTIC ABOUT PASSING AN EFFECTIVE BUDGET. WE WILL HAVE TO BE STRONG ENOUGH TO DEAL WITH THEM WITH THE FACTS AS WE FIND THEM.

WE CAN'T TAKE MUCH COMFORT FROM THE DECLINE IN INTEREST RATES LAST YEAR. IT WASN'T RONALD REAGAN'S WHITE HOUSE, BUT RATHER PAUL VOLCKER'S FEDERAL RESERVE THAT PLAYED THE MAJOR ROLE IN BRINGING THOSE RATES DOWN BY FLEXING SOME ON MONETARY POLICY. OVER THE LAST THREE WEEKS, INTEREST RATES HAVE BEGUN TO EDGE BACK UP BECAUSE THE FINANCIAL MARKETS SEE THE TRUE SIZE OF THE DEFICIT AND HOW LITTLE YOUR BUDGET DOES TO REDUCE IT.

THE WHITE HOUSE HAS CLEARLY SEEN THE CONNECTION BETWEEN BIG DEFICITS AND HIGH INTEREST RATES. IN FACT, THE PRESIDENT IS TALKING MORE THAN EVER ABOUT THE THREAT OF A STRUCTURAL DEFICIT. AND I SHARE HIS WORRY. BUT WHEN HE SAYS DOMESTIC SPENDING IS THE SOLE SOURCE OF THAT STRUCTURAL DEFICIT, THE PRESIDENT AND I PART COMPANY.

SPENDING FROM MEDICARE AND SOCIAL SECURITY IN FISCAL 1983 ACCOUNTS FOR 6.9 PERCENT OF GNP. BY FISCAL 1988, THE PERCENTAGE WILL BE DOWN 6.7 PERCENT, A DECLINE OF 0.2 PERCENT. MEANS-TESTED PROGRAMS, WHICH STAND AT 0.9 PERCENT OF GNP IN FISCAL 1983, WILL BE DOWN TO 0.6 PERCENT BY FISCAL 1988.

BY CONTRAST, DEFENSE SPENDING TAKES UP 6.7 PERCENT OF GNP IN FISCAL 1983. BY FISCAL 1984, IT CLIMBS TO 7.9 PERCENT UNDER THE REAGAN PROGRAM, MEANING ANOTHER 2.2 PERCENT ADDED TO THE DEFICIT.

ON THE REVENUE SIDE, OVERALL ADMINISTRATION TAX CUTS PRODUCED REDUCTIONS IN FISCAL 1983 OF $68.2 BILLION, OR 2.1 PERCENT OF GNP. BY FISCAL 1988, THE CUTS IN REVENUES WILL BE AT $207.4 BILLION -- 4.3

PERCENT OF GNP, MORE THAN TRIPLING THE LOSS ALREADY EXISTING, AND VIRTUALLY GUARANTEEING A MAMMOTH DEFICIT.

THE PRESIDENT INSISTS THE DEFENSE INCREASE IS NOT A PROBLEM SINCE HE SAYS IT WOULD MERELY RESTORE THE SHARE OF GNP DEFENSE TOOK IN 1960. BUT THAT IGNORES THE FACT THAT OVER THE YEARS, THE UNITED STATES HAS ACQUIRED MAJOR SOCIAL RESPONSIBILITIES LIKE MEDICARE AND EDUCATION OF THE HANDICAPPED WHICH NO ONE WANTS TO ELIMINATE. BY FISCAL 1988, PROGRAMS LIKE THESE WILL COST 3.5 PERCENT OF GNP. IF, AS IS LIKELY, WE KEEP THESE PROGRAMS WHILE ADDING ON TWO OR THREE PERCENT OF GNP IN DEFENSE SPENDING, TOTAL SPENDING WILL GO UP, NOT DOWN. ANY TAX CUT, THEREFORE, SIMPLY ADDS TO THE STRUCTURAL DEFICIT. THUS, IT'S NOT DOMESTIC SPENDING BY ITSELF, BUT TAX CUTS AND DEFENSE HIKES THAT PRODUCE THE STRUCTURAL DEFICIT.

MILTON FRIEDMAN, NO TAX-AND-SPEND LIBERAL, HAS WRITTEN THAT THE TOTAL TAX BURDEN ON THE AMERICAN PUBLIC IS NOT THE PRICE WE PAY IN ACTUAL TAXES, BUT RATHER THE TOTAL AMONT WE ACTUALLY SPEND. "ANY DEFICIT", SAYS FRIEDMAN, "IS BORNE BY THE PUBLIC IN THE FORM OF HIDDEN TAXES . . ." MEANING EITHER AGGRAVATED INFLATION OR, ". . . THE EVEN MORE EFFECTIVELY HIDDEN TAX CORRESPONDING TO BORROWING FROM THE PUBLIC.

FRIEDMAN MAKES A TELLING ARGUMENT, ESPECIALLY SINCE THE 25 PERCENT TAX CUT AND THE SIZEABLE INCREASE IN DEFENSE SPENDING WERE BOTH "EXPENSES" PAID WITH MONEY WE DIDN'T HAVE. WE HAVE BEEN RUNNING GOVERNMENT ON A CREDIT CARD AND SOME DAY WE WILL HAVE TO PAY THE BILL.

MY BIG TROUBLE WITH YOUR TAX PROPOSAL IS THAT IT IS TOO LITTLE, TOO LATE. THE PRESIDENT'S BUDGET INCLUDES A STANDBY TAX LIMITED TO

1 PERCENT GNP. WELL, 1 PERCENT OF GNP JUST DOESN'T PAY THE BILLS THE ADMINISTRATION WANTS TO RUN FOR DOMESTIC AND DEFENSE SPENDING. AND YOU, AS THE SECRETARY WHO HAS TO FUND THE NATIONAL DEBT EACH YEAR, OUGHT TO BE SENSITIVE TO THE FACT THAT LEAVING 200 BILLION DEFICITS IN PLACE FOR THE NEXT THREE YEARS WILL PLACE A STRAIN ON CREDIT MARKETS, AND WILL ADD 20 BILLION A YEAR TO OUR INTEREST COSTS BY 1986.

WE ARE LIKELY TO HEAR A GOOD DEAL MORE ABOUT THE THIRD YEAR OF THE TAX CUT BEFORE THE BUDGET DEBATE RUNS ITS COURSE, SO LET'S BE CLEAR ABOUT THE ISSUE. I TOLD ALICE RIVLIN YESTERDAY, AND I WILL TELL

YOU TODAY THAT THE MAIN CONCERN IS NOT HOW MUCH THE ECONOMY WILL BE STIMULATED BY THE JULY TAX CUT. THE ISSUE IS HOW MUCH THE BUDGET WLL BE HAMSTRUNG BY THE AGGREGATE, PERMANENT AND FUNDAMENTAL CUT IN THE TAX BASE.

VIRTUALLY THE WHOLE ADMINISTRATION IS TALKING ABOUT STIMULUS. VIRTUALLY EVERYONE IN THE ADMINISTRATION IS TELLING US HOW IMPORTANT IT IS FOR THE SHORT-RANGE BENEFIT OF THE ECONOMY. BUT VIRTUALLY NO ONE IN THE ADMINISTRATION IS TALKING ABOUT THE EFFECT OF A PERMANENTLY SHRUNKEN TAX BASE OVER THE YEARS AHEAD.

I CAN TELL YOU WHAT THE EFFECT WILL BE. IT WILL BE TO INSTITUTIONALIZE STRUCTURAL DEFICITS -- SPENDING LEVELS IN EXCESS OF REVENUES THAT CANNOT BE ELIMINATED BY DOMESTIC CUTS, UNLESS THE CUTS YOU ARE WILLING TO MAKE INVOLVE WHOLESALE ELIMINATION OF PROGRAMS LIKE MEDICARE OR EDUCATION PROGRAMS, OR CHILD NUTRITION PROGRAMS.

THOSE KIND OF CUTS ARE NOT GOING TO BE MADE MR. SECRETARY. YOU KNOW IT AS WELL AS I DO. AND DON'T TELL ME IT'S BECAUSE CONGRESS DOESN'T HAVE THE POLITICAL COURAGE TO MAKE THEM. THE CUTS WON'T BE MADE IN THOSE PROGRAMS BECAUSE THEY CONSTITUTE THE VERY SAFETY NET THIS ADMINISTRATION HAS PLEDGED NOT TO DISMANTLE. THOSE ARE THE VERY PROGRAMS WHICH PEOPLE RELY ON TO GIVE THEM A FOOTHOLD, TO HELP THEM GET AN EDUCATION, TO HELP THEM EAT, TO HELP THEM OBTAIN MEDICAL CARE.

IN CLOSING, I'D LIKE TO QUOTE THE WORDS OF THE MAN WHO WILL BE WITH US TOMORROW, MARTIN FELDSTEIN, CHAIRMAN OF THE PRESIDENT'S COUNCIL ON ECONOMIC ADVISORS. A YEAR AGO THIS WEEK, HE TOLD TIME MAGAZINE, "THE ADMINISTRATION HAS PUT ITSELF IN AN IMPOSSIBLE SITUATION." AND IT'S THE SITUATION I'VE JUST DESCRIBED, A STRUCTURAL CHANGE IN THE TAX BASE THAT'S OUT OF TOUCH WITH BOTH OUR DOMESTIC AND DEFENSE NEEDS. UNLESS THAT TAX BASE IS ADJUSTED, WE WILL CONTINUE TO HAVE STRUCTURAL DEFICITS.

IF SENSIBLE REVENUE ADJUSTMENTS ARE NOT MADE NOW, WE RUN THE RISK OF A $2 TRILLION NATIONAL DEBT BY 1986. TO HEAD THAT OFF, WE WILL NEED THE PRESIDENT'S HELP AND WE WILL NEED YOURS. BOTH OF YOU WILL BE GIVEN EVERY CHANCE TO PROVIDE IT AS THE BUDGET PROCESS CONTINUES.

Chairman DOMENICI. Mr. Secretary, you have a prepared statement. We will make it a part of the record [1] and we will let you handle that statement as you please at this point.

STATEMENT OF HON. DONALD T. REGAN, SECRETARY OF THE TREASURY

Secretary REGAN. Mr. Chairman, what I would like to do is to summarize my full statement that I am submitting for the record.

Mr. Chairman and members of the committee, it is a pleasure to be able to tell you that the recession now appears to be over, and the fundamental elements of economic recovery are now largely in place.

Industrial production rose a revised 0.1 percent in December, and a strong 0.9 percent in January. Historically, the upturn in industrial production has marked the end of recessions.

There has been clear progress on inflation, and consumer price growth has dropped dramatically from 12.4 percent in 1980 to 3.9 percent in 1982.

Producer prices posted a 1 percent drop in January—the largest in the history of the index.

Interest rates, which had been driven to record levels by inflation, are down from peak levels of 21½ percent on the prime in December 1980 to 11 percent currently.

The unemployment rate for the civilian labor force fell sharply from 10.8 percent in December to 10.4 percent in January.

The index of leading indicators has risen for 8 out of the last 9 months.

Housing is in the midst of a rapid recovery.

Retail sales have begun to firm.

Business trimmed inventories sharply in the final quarter of last year.

THE TYPICAL RECOVERY

We would all hope for a vigorous recovery. The typical postwar recovery path is shown in the first chart, which is chart III of the submitted testimony.[2] The five typical recoveries contained in the average line in the chart were remarkably similar. Gains over the first eight quarters from the real GNP trough were within an extremely narrow range of 5 to 6 percent at an annual rate.

THE OUTLOOK FOR THE ECONOMY

A vigorous recovery of this type would be most welcome. It would certainly help ease the Nation's budgetary problems. However, the administration's official forecast contains a fairly conservative estimate of real growth at a 3.1 percent rate during the four quarters of 1983, rather than the typical recovery growth rate of about twice that much.

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[1] See p. 407.

[2] See p. 425.

POLICIES FOR THE RECOVERY

In setting policy for the remainder of the 1980's, we must not revert back to the overly stimulative monetary and fiscal policies pursued at times in the past. That would surely lead to a resurgence of inflation and a new round of rising interest rates. Further, we must not reverse the fundamental tax restructuring put in place in 1981, for that too would retard growth and cost jobs.

Spending reduction will contribute to the recovery, and the recovery will contribute to deficit reduction. In fact, a strong recovery with 1⅓ percent more real growth per year than in our forecast would bring the budget to near balance by 1988, provided we also curb the growth of Federal outlays.

However, if we fail to bring spending under control and if recovery is slow, we will face a deficit problem which is larger and longer-lasting than we can afford.

The deficit reduction program that we propose contains four basic elements.

The first is a partial or total freeze on 1984 cost of living adjustments in Federal programs.

The second element of our budgetary program contains measures to control the so-called uncontrollables, taking special care to protect those truly in need.

The third element is a cutback of $55 billion in defense outlays from original plans.

Fourth is a set of proposals involving the revenue side of the budget.

Over the last two decades, there has been a gradual upward trend in unified budget receipts as a percent of GNP, shown in the top line of the next chart, which is chart V of the submitted testimony.[1] Taxes as a share of GNP will remain high in the 1980's, in spite of our tax reduction program. As shown in the bottom line of the chart, a major shift in the composition of receipts has been the rising share of social insurance and other payroll taxes.

No major tax increases will be proposed for the years 1983 and 1984, and the President is committed to retaining the third year of the tax cut and the indexing provision beginning in 1985. In addition, the President has directed the Treasury Department to undertake a long-term study of ways to simplify the Federal tax system.

MISCONCEPTIONS ABOUT TAX ACT

I want to discuss briefly the tax cut enacted in 1981 and address some of the misconceptions about the act, namely that the tax cut was much too large and caused the budget deficits we are facing.

Rather than being too large, the tax cut enacted in 1981 just barely offsets the rising tax burden on the economy.

Between fiscal 1981 and 1988, ERTA reduces taxes by $1,138 billion, a substantial amount. But a substantial tax cut is needed to offset the equally substantial tax increases facing the American taxpayers between fiscal 1981 and 1988.

Last summer's tax bill raises taxes by $281 billion.

The gasoline tax bill raises taxes by $21 billion.

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[1] See p. 427.

Inflation-induced bracket creep raises taxes by $489 billion.

Previously scheduled social security taxes raise taxes by $214 billion, and the proposed bipartisan social security rescue plan will raise $56 billion.

The total tax increases amount to $1,061 billion, leaving the taxpayers with a net tax cut of only $77 billion between 1981 and 1988—about $10 billion per year.

Rather than destroying the tax base, as many have suggested, the 1981 tax cut merely "returns revenues as a percentage of GNP to approximately the levels that prevailed in the 1960's and 1970's," according to the Congressional Budget Office's recent report on the budget.

Under the administration budget, taxes as a percent of GNP for fiscal years 1983–86 will average 19.2 percent. This is a level slightly higher than the 18.6 percent average for the 1960's and the 18.9 percent average for the 1970's. It is low only in comparison to the high tax level of the previous administration, which reached 20.9 percent in fiscal 1981.

And as CBO points out, the tax burden during the 1980's "would have moved well above the all-time record of 21.9 percent of GNP reached in 1944" without the tax cuts.

CBO also reports that due to the tax cut individual income taxes as a percent of taxable personal income will average 12.3 percent for 1984–88. This is a level below the 14.3 percent rate in 1981, the highest level in history, but close to the 12.2 percent average rate for the 1970's.

UNFAIRNESS OF REPEAL

Without the tax cut, CBO notes, the tax rate would have risen to an unprecedented 18.4 percent of taxable personal income by 1988. And if indexing is repealed, the tax rate would rise to a near-record level of almost 14 percent of taxable personal income by 1988.

Repeal of the remainder of the tax cut would strike disproportionately at lower income workers and retirees. Seventy-two percent of the benefits of the third year tax cut goes to those earning less than $50,000 a year. Repeal of the third year would cause a 13.9-percent jump in tax liability for those with less than $10,000 in adjusted gross income, a 12-percent jump for those between $20,000 and $30,000, and only a 2.7-percent jump for those with $200,000 and over.

The unfairness of repeal is even more pronounced with indexing. Seventy-eight percent of the benefits of indexing goes to those earning less than $50,000 a year. Assuming 4.5 percent inflation, repealing indexing would produce a 9.4-percent jump in tax liability for those with less than $10,000 in adjusted gross income, a 3.2-percent jump for those between $20,000 and $30,000, and a one-half-percent jump for those with $200,000 and over. Even worse, these latter increases from repeal of indexing would be repeated each year as long as inflation continues.

Indexing is of relatively greatest importance to lower bracket taxpayers. First, the lower brackets are narrowest in percentage terms, and inflation causes income to rise through the brackets fastest at the bottom. Second, for those in the lower brackets, personal exemptions and the zero bracket are large relative to total income. Indexing keeps these exemptions from losing real value, and keeps inflation from pushing those too poor to owe tax onto the tax rolls. Third, upper income taxpayers may already be in the top tax bracket, with no higher bracket into which to be pushed.

In addition to the significance for individuals of the third year cut and indexing, both of these measures are of critical importance for small businesses. Over 85 percent of small businesses pay only personal income tax. Furthermore, small businesses tend to be labor intensive, and the administration's program of reducing marginal tax rates and indexing will help limit wage pressures, enabling American labor to maintain competitiveness with workers overseas.

UNFAIR DOUBLE BURDEN

There have been suggestions that proposals to delay retirement COLA's or pay increases should be accompanied by repeal of the third year or indexing to increase fairness, as if these proposals somehow impact different groups. In fact, this would impose an unfair double burden on workers, savers, and pensioners of all income levels.

We are asking social security recipients to accept a 6-month delay in their cost-of-living increase, and the taxation of a portion of benefits for upper income retirees, to help save the social security system. It would be unfair to raise tax rates on their other pension or interest income by repealing the third year, or to subject their fixed retirement incomes to continued bracket creep year after year.

Federal workers are being asked to accept a COLA freeze in fiscal year 1984. Many private sector workers are renegotiating their labor contracts to preserve their jobs. They are also facing higher payroll taxes to help preserve the social security system. This is particularly true of self-employed small businessmen, who will pay more, both on their own salaries, and as employers of others. It would unfairly compound their difficulties if the third year were repealed, and recompound them every year thereafter if indexing is removed and income tax rates are made to rise continually.

The only beneficiaries of repeal of the third year and indexing would be here in Washington. As for the country at large, substantial job loss would result as American workers were made less competitive by a higher tax burden, and as savers withdrew from the market as rising tax rates lowered the return on their savings.

NO MAJOR NEAR-TERM TAX INCREASES PROPOSED

While no major near-term tax increases will be proposed, there are several tax initiatives in the budget. These include: three new proposals designed to help restrain health costs, encourage family savings for higher education, and provide special incentives to hire the long-term unemployed; three proposals we are resubmitting to provide tuition tax credits, establish enterprise zones, and aid the

Caribbean Basin; tax initiative recommended by the Social Security Commission.

In addition, the President has proposed a contingency tax plan designed to raise revenues of about 1 percent of GNP in the event that, after Congress has adopted the spending reduction proposals, there is insufficient economic growth to reduce the deficit below 2½ percent of GNP.

The contingency tax alternative shown in the budget raises $146 billion over the 36-month period beginning October 1, 1985. The contingency tax plan would not go into effect unless the economy is growing on July 1, 1985.

The final chart, which is chart VI in the submitted testimony,[1] shows the effect on the deficit that the contingency tax would have if it were implemented. It also shows the budget picture under a stronger expansion. The deficit path under high growth reflects the assumption that real GNP increases 1⅓ percentage points faster than in the official forecast path, starting with fiscal year 1983. Such growth would be in line with the performance from the end of 1960 to late 1966.

WORK CLOSELY WITH OTHER NATIONS

Finally, in setting the proper course of policy for the 1980's, we must work closely with the other nations. The members of the International Monetary Fund (IMF) have agreed in principle on measures to strengthen the ability of the IMF to deal with current strains in the international financial system. These measures include an increase in IMF quotas and an expansion of the General Arrangements to Borrow (GAB). The proposed increase in the U.S. quota would be about $5.8 billion, and our share of the increase in GAB would be $2.6 billion, for a total of about $8.4 billion.

The participation of the United States in the increase in IMF resources is an essential complement to domestic measures for economic recovery. This does not involve net budget outlays or affect the budget deficit because any transfers by the United States to the IMF are simultaneously offset by an increase in our international monetary reserve assets. I urge prompt approval by the Congress.

I believe we have fashioned a reasonable approach to the deficit problem that should be credible to the financial markets and the American people. We are renewing our commitment to limiting the tax burden, to reducing the growth of Federal spending, and to a moderate and steady monetary policy.

Our program is designed to reduce unemployment by fostering steady noninflationary economic growth throughout the decade. Together with the Congress, we can make it work.

Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you, Mr. Secretary.

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[1] See p. 428.

TESTIMONY OF THE HONORABLE DONALD T. REGAN
SECRETARY OF THE TREASURY
BEFORE THE
SENATE BUDGET COMMITTEE

Mr. Chairman and Members of the Committee:

It is a pleasure to meet with you today and to discuss the Administration's 1984 budget proposals. The development of a sound fiscal policy was one of the central objectives of the Reagan Administration when it came into office two years ago. For too long a time Americans had watched the share of GNP accounted for by Federal spending and taxes move upward. As the government siphoned off resources from the private sector and the money supply expanded, economic activity stagnated and inflation soared.

In February 1981 the Administration put before Congress a four point plan to revitalize the economy. Our program included spending restraint, tax reductions, regulatory reform, and support of the Federal Reserve's efforts to attain gradual, steady reduction in the rate of monetary growth.

The transition to a noninflationary environment has been somewhat more difficult than anticipated. We have seen two years of serious economic recession as a result of the inflation/tax spiral and monetary volatility.

However, the recession now appears to be over. The unemployment rate declined in January for the first time since July 1981. There has been clear progress on inflation, and consumer price growth has dropped dramatically from 12.4 percent in 1980 to 3.9 percent in 1982. The producer price index fell by 1.0 percent in January -- the sharpest drop in the history of the index. Interest rates, which had been driven to record levels by inflation, are down from peak levels of 21-1/2 percent on the prime in December 1980 to 11 percent currently, and the stock market this week made new highs. Indicators such as housing, inventories, and real income show the economy is poised for recovery. Despite these favorable developments, further reductions in unemployment are still necessary.

The task now is to encourage the renewal of economic growth to reduce unemployment and provide productive job opportunities in the private sector. In so doing we must not repeat the errors of the past and return to an inflationary economy.

The current domestic situation is complicated by the existence of large Federal budget deficits and the threat of even larger ones in years to come. These budget deficits will have to be reduced, since their persistence would inevitably lead to very adverse consequences for the U.S. economy and its financial markets.

Many of the economic difficulties we face at home are also faced by countries abroad. The entire international economy is experiencing a severe slowdown, complicated by the special debt-servicing problems of a number of countries. My prepared statement today deals primarily with the U.S. domestic economy, but it is obvious that the domestic and international situations are closely linked. The clear need in both cases is to encourage expansion rather than undergo further contraction.

It is important to recognize that current difficulties are the culmination of a long period of deteriorating economic performance in this country. The U.S. economy was in deep trouble long before the current recession began. It follows that our policies must aim at lasting long-run solutions. There are no quick cures.

Inflation has led to a roughly parallel rise in key interest rates. As shown in Chart I on interest rates and inflation, the 3-month Treasury bill rate followed the rate of inflation very closely over most of the period from the early 1960's to present. Thus, inflation appears to have been a major factor in the increase in the bill rate during that time.

Rising rates of inflation after the mid-1960's did not lead to more rapid economic growth for any sustained period of time. Quite the contrary. Inflation and its inevitable consequence of higher interest rates finally choked off real growth altogether.

Approach of the Reagan Administration

The Administration's primary economic goal upon coming to office was a fundamental restructuring of the economy, including:

- bringing inflation under control;
- shifting the composition of activity away from government spending toward more productive endeavors in the private sector;
- providing an environment which would reward innovation, work effort, saving and investment, and in which free-market forces could operate effectively.

Over the past two years we have seen evidence that the Administration's program is working. The fundamental elements of recovery are now largely in place. Inflation has been brought under control. Interest rates are coming down, as shown in Chart II. Real wage growth is being restored. In addition, there have been other improvements -- notably in productivity growth and saving behavior -- which mark a shift away from the problems that contributed to sluggish economic performance in recent years.

Within this framework of very significant achievements, there remains the fact that the economy has been in recession and unemployment is still high. The civilian unemployment rate of 10.4 percent in January is, of course, a matter of great concern. The President has indicated in his State of the Union Message that he will be submitting special legislation to help deal with the problem.

The Current State of the Economy

The economy now stands poised for recovery. In fact, the recovery appears to be underway at this moment. It has been much longer in coming than we, or for that matter nearly all forecasters, had expected.

The delay occurred primarily because of the persistence of high interest rates and because of developments in the international sphere. On the international front, the economies of our leading trading partners continued to weaken. Weakness among all the industrialized nations was self-reinforcing. Furthermore, the financial difficulties of some of the newly industrializing nations had adverse impacts on economic activity here. These forces, combined with a general hesitancy on the part of the consumer, led to another round of inventory cutting in the second half of 1982 and delayed the expected turnaround of the economy.

Signals of an Economic Upturn

There are now clear signals that the economy has turned around and that the recession is now behind us. To summarize these signals:

- The unemployment rate for the civilian labor force fell sharply from 10.8 percent in December to 10.4 percent in January.
- The index of leading indicators has risen for eight out of the last nine months.
- Housing is in the midst of a rapid recovery.
- Business trimmed inventories sharply in the final quarter of last year. Historically, a cleanout of inventories typically has been followed by a shift back to higher rates of production.
- Retail sales have begun to firm.
- Total industrial production stabilized in December and evidence available on employment and workhours in January indicates that production will almost certainly rise for the month.

The Typical Recovery

We would all hope for a vigorous recovery, not unlike those which occurred in the past. The typical postwar recovery path is shown in Chart III. Excluded from it are two atypical recoveries -- the first of which included the Korean War buildup and the second which got underway late in 1980 but was short-lived. The five recoveries contained in the average line in the chart were remarkably similar. Gains over the first eight quarters from the real GNP trough were within an extremely narrow range of 5 to 6 percent at an annual rate.

The contributions of GNP components to real growth during the typical recovery are shown in Chart IV. As it indicates, much of the initial thrust for expansion comes from:

- a resurgence in homebuilding activity, such as currently is underway;
- a swing in inventory investment from decumulation in the later stages of recession to accumulation; and

- a major contribution from consumer spending, with purchases of consumer durables registering particularly large increases.

By contrast, Federal spending normally declines as a share of GNP during recovery, and is not necessary for promoting expansion.

The Outlook for the Economy

A vigorous recovery of the type outlined would be most welcome. It would certainly help ease the Nation's budgetary problems. However, we recognize that the serious problems still confronting us may well hold growth during the next year or two below the typical recovery pattern.

- Our overall trade balance is likely to register further marked deterioration in the coming year.

- Real interest rates may persist at high levels, though remaining below those prevailing a year ago.

- The economy is in the process of undergoing marked structural change. Some of our industries may not quickly regain the vitality they experienced in the 1950's and 1960's. The shift of resources to emerging industries will take time.

- Most fundamentally, we are not yet fully out of the inflationary woods, and we cannot afford to direct monetary and fiscal policy toward excessively rapid economic expansion.

For these reasons, the Administration's official forecast contains a fairly conservative estimate of real growth at a 3.1 percent rate during the four quarters of 1983, rather than the typical recovery growth rate of about twice that much. The favorable results in the January employment survey indicate that recovery could well be stronger than forecasted, which we would certainly welcome. Growth is expected to average in the 4 percent range in 1984 and the years beyond.

The Congressional Budget Office forecast for 1983 and 1984 is roughly similar to the Administration's. It also shows moderate growth, well below the average cyclical recovery. Both forecasts are cautious and note uncertainty about the recovery.

However, the CBO is somewhat more optimistic about real GNP growth, unemployment, inflation, and interest rates in 1983 and 1984. The differences are modest in the first year and narrow in the second. According to CBO:

- Real GNP is expected to grow by 4 percent over the four quarters of 1983 and 4.7 percent during 1984 (compared to Administration estimates of 3.1 percent and 4.0 percent).

- Unemployment continues at very high levels, declining only gradually during the recovery, with average unemployment rates of 10.6 and 9.8 percent for the civilian labor force in calendar years 1983 and 1984. The Administration estimates 10.7 percent and 9.9 percent, respectively.

- The GNP deflator rises 4.7 percent in 1983, according to CBO estimates, and 4.6 percent in 1984 (compared to Administration estimates of 5.6 percent and 5.0 percent, respectively).

On balance, the CBO forecast shows somewhat stronger growth from 1983 through 1986, although somewhat lower growth in the following three years.

Policies for the Recovery

In setting policy for the remainder of the 1980's, we must recognize what we must not do. We no longer have the freedom of action to revert back to the overly stimulative monetary and fiscal policies pursued at times in the past, for these would surely lead to a resurgence of inflationary pressures and a new round of rising interest rates. Further, we must not reverse the fundamental tax restructuring put in place in 1981, for this was designed to provide the noninflationary incentives without which the private sector would continue to wither.

Policies for a Changing Economic Structure

For years private sector initiative and dynamic market forces have been stifled by unnecessary Federal regulation. It is important that we carry through with policies of reducing the regulatory burden on private industry. Noteworthy successes have been achieved in this area, particularly in the deregulation of the financial system. For the first time in the postwar period, small investors can count on being able to obtain market rates of return on their savings from banks and thrift institutions.

Further, we recognize that our economy and those of the other industrialized nations are undergoing a period of restructuring. This is an era of rapid technological change, and comparative advantage in the production of many goods and services is shifting from the already developed to the newly developing nations. Those nations which expend all their energies shoring up declining industries and resisting change will find themselves with industrial bases that are obsolete and with declining relative standards of living. Their more foresighted and innovative neighbors will be moving forward and capturing newly opening markets.

Government can ease the painful process of structural change within the economy. We have significant new initiatives in the budget to fight unemployment and we are working with the Congress on additional jobs programs.

Finally, in setting the proper course of policy for the 1980's, we must work closely with the other industrialized and newly industrializing nations of the world. The members of the International Monetary Fund (IMF) have agreed in principle on measures to strengthen the ability of the IMF to deal with current strains in the international financial system. These measures include an increase in IMF quotas of 47.5 percent, from SDR 61 billion (the equivalent of about $67 billion) to SDR 90 billion (about $99 billion), and an expansion of the General Arrangements to Borrow (GAB) from about SDR 6.5 billion ($7 billion) to SDR 17 billion (about $19 billion). The proposed increase in the U.S. quota would be about SDR 5.3 billion, to a new level of SDR 17.9 billion, and our share of the expanded GAB would be SDR 4.25 billion.

The participation of the United States in the increase in IMF resources is an essential complement to domestic measures for economic recovery and represents a valuable investment in defense of the economic interests of the American farmer, laborer, businessman, and consumer. Legislation providing for budget authorization and appropriation for the U.S. share of the increase in IMF resources will be submitted in the near future. The increase in U.S. funding for the IMF, SDR 7.7 billion ($8.5 billion), does not involve net budget outlays or affect the budget deficit because any transfers by the United States to the IMF are simultaneously offset by an increase in our international monetary reserve assets. I urge prompt approval by the Congress.

Monetary Policy

In addition to policies aimed at facilitating structural changes within the economy, we must maintain steady monetary and fiscal policies directed at reinvigorating economic activity. Steady, predictable money supply growth at a noninflationary pace has been, and continues to be, one of the major goals of the Administration's economic program. The Federal Reserve's efforts to achieve that goal have been complicated by a number of factors, such as far-reaching institutional changes in the banking and thrift industries. Nevertheless, the Fed has generally been successful, albeit in a somewhat erratic fashion.

Monetary policy faced a difficult and uncertain situation during much of the last year. Rapid institutional change in the form of new money market instruments blurred the boundaries between the various aggregates and made the achievement of any target rates of growth unusually difficult. There is also some indication that the recession may have led to an increased demand for liquidity and precautionary balances. In 1982, growth in monetary velocity -- the rate at which money is used -- turned negative for the first time in nearly three decades. Under the unusual economic and institutional circumstances of 1982, some temporary offset in the form of above-target rates of monetary growth was probably desirable.

The Federal Reserve's efforts to slow money growth have been accompanied by some volatile short-run swings. Growth in M1 was actually negative on a 13-week basis by mid-summer of last year, and then soared to the double-digit range by the end of the year. This recent acceleration has caused some observers to conclude that the fight against inflationary money growth has been abandoned. That is not true. Both the Administration and the Federal Reserve remain committed to the long-run goal of providing money growth at a noninflationary pace consistent with a steady and sustainable expansion of economic activity.

Fiscal Policy

The objectives of our fiscal policy upon coming to office two years ago were two-fold. First, we believed and still believe it was imperative to correct the disincentives to economic performance that had been built into the tax structure over the years. These disincentives arose in large measure, not by design, but through the interaction of a high rate of inflation with a progressive tax system and historical cost accounting of depreciable assets. Second, it was equally imperative to reverse the seemingly inexorable growth of Federal spending, thereby freeing resources for use in the private sector. In moving to achieve these goals, we faced one major constraint, namely that our defense establishment had been allowed to deteriorate badly, so that our national survival mandated a stepped-up rate of defense spending.

The tax reforms that were put in place were designed primarily to restore an adequate rate of return for investment in plant and equipment and to put a halt to the steady ratchetting upward of marginal tax rates on labor and savings income. The investment incentives were necessary to bring long-depressed rates of business capital investment and productivity growth back up to acceptable standards. For individuals, the tax cuts were needed to protect incentives and purchasing power, and to keep American labor competitive in world markets. For the average taxpayer, they will only result in an actual dollar tax cut in 1983, after allowance for the effects of bracket creep and higher social security taxes. And that 1983 cut and tax indexing will be needed to offset bracket creep and increases in social security taxes scheduled to take effect in the future. These measures will greatly improve the competitive standing of American capital and labor in the world as economic recovery proceeds.

I want to discuss briefly the tax cut enacted in 1981 and address some of the misconceptions about the act, namely that the tax cut was much too large and as a result, it destroyed our revenue base and caused the budget deficits we are facing.

Rather than being too large, the tax cut enacted in 1981 just barely offsets rising tax burden on the economy.

Between fiscal 1981 and 1988, ERTA reduces taxes by $1,138 billion, a substantial amount. But a substantial tax cut is needed to offset the equally substantial tax increases facing the American taxpayers between fiscal 1981 and 1988.

- Last summer's tax bill raises taxes by $281 billion.
- The gasoline tax bill raises taxes by $21 billion.
- Inflation-induced bracket creep raises taxes by $489 billion.
- Previously-scheduled social security taxes raise taxes by $214 billion, and the proposed bipartisan social security rescue plan will raise $56 billion.

The total tax increases amount to $1,061 billion, leaving the taxpayers with net tax cut of only $77 billion between 1981 and 1988.

Rather than destroying the tax base, as many have suggested, the 1981 tax cut merely "returns revenues as a percentage of GNP to approximately the levels that prevailed in the 1960's and 1970's," according to the Congressional Budget Office's recent report on the budget.

Under the Administration budget, taxes as a percent of GNP for fiscal years 1983 to 1986 will average 19.2 percent. This is a level slightly higher than the 18.6 percent average for the 1960's and the 18.9 percent average for the 1970's. It is low only in comparison to the high tax level of the previous Administration, which reached 20.9 percent in fiscal 1981.

And as CBO points out, the tax burden during the 1980's "would have moved well above the all-time record of 21.9 percent of GNP reached in 1944" without the tax cuts.

CBO also reports that due to the tax cut individual income taxes as a percent of taxable personal income will average 12.3 percent for the 1984 to 1988 period. This is a level below the 14.3 percent rate in 1981, the highest level in history, but close to the 12.2 percent average rate for the 1970's.

Without the tax cut, CBO notes, the tax rate would have risen to an "unprecedented" 18.4 percent by 1988. And without indexing, the tax rate would rise to the near-record level of almost 14 percent by 1988.

Repeal of the remainder of the tax cut would strike disproportionately at lower income workers and retirees. Repeal of the third year would cause a 13.9 percent jump in tax liability for those with less than $10,000 in adjusted gross income, a 12 percent jump for those between $20,000 and $30,000, and only a 2.7 percent jump for those with $200,000 and over.

The unfairness of repeal is even more pronounced with indexing. Assuming 4.5 percent inflation, repealing indexing would produce a 9.4 percent jump in tax liability for those with less than $10,000 in adjusted gross income, a 3.2 percent jump for those between $20,000 and $30,000, and a one-half percent jump for those with $200,000 and over. Even worse, these latter increases from repeal of indexing would be repeated each year as long as inflation continues.

Indexing is of relatively greatest importance to lower bracket taxpayers. First, the lower brackets are narrowest in percentage terms, and inflation causes income to rise through the brackets fastest at the bottom. Second, for those in the lower brackets, personal exemptions and the zero bracket are large relative to total income. Indexing keeps these exemptions from losing real value, and keeps inflation from pushing those too poor to owe tax onto the tax rolls. Third, upper income taxpayers may already be in the top tax bracket, with no higher bracket into which to be pushed.

In addition to the significance for individuals of the third year cut and indexing, both of these measures are of critical importance for small businesses. Small businesses tend to be labor intensive, and the Administration's program of reducing marginal tax rates and indexing will help limit wage pressures, enabling American labor to maintain competitiveness with workers overseas. In addition, because over 85 percent of small businesses pay only personal income tax, the Administration's tax program will help directly to safeguard the value of their earnings.

There have been suggestions that proposals to delay retirement COLAs or pay increases should be accompanied by repeal of the third year or indexing to increase fairness, as if these proposals somehow impact different groups. In fact, this would impose an unfair double burden on workers, savers, and pensioners of all income levels who are simultaneously income recipients and taxpayers.

We are asking social security recipients to accept a 6-month delay in their cost-of-living increase, and the taxation of a portion of benefits for upper income retirees to help save the Social Security System. It would be unfair to raise tax rates on their other pension or interest income by repealing the third year, or to subject their fixed retirement incomes to continued bracket creep year after year.

Federal workers are being asked to accept a COLA freeze in FY 1984. Many private sector workers are re-negotiating their labor contracts to strengthen their competitiveness and preserve their jobs. They are also facing higher payroll taxes to help preserve the Social Security System. This is particularly true of self-employed small businessmen, who will pay more on their own salaries and as employers of others. It would unfairly compound their difficulties if the third year were repealed, and recompound them every year thereafter if indexing is removed and income tax rates are made to rise continually.

The only beneficiaries of repeal of the third year and indexing would be here in Washington. As for the country at large, substantial job loss would result as American workers were made less competitive by a higher tax burden, and as savers withdrew from the market as rising tax rates lowered the return on their savings.

We were relatively successful in working with the Congress to achieve our goals of tax reform, but we were less successful in the area of outlay control. A major portion of the savings we had proposed in our original budget did not receive favorable action. This, along with much weaker economic activity than expected, has left us facing the prospect of large deficits even as the economy recovers.

The proposals in the FY-1984 Budget are directed at the crucial task of restoring noninflationary economic growth. This requires the preservation of the investment and work incentives provided by the tax reforms of 1981 and a reduction in the high deficits and interest rates which lie ahead unless corrective action is taken to bring government outlays under control.

The tax reforms already enacted will enable us to make good progress in rebuilding and modernizing America's plant and equipment as the recovery progresses. Incentives are in place to encourage saving and investment and to lower the cost of new machinery and structures. Taxes on American labor are coming down. These reforms will lead to a more productive, more competitive United States. The capital formation program will be financed by higher levels of personal saving, more generous capital consumption allowances, and higher retained earnings as profits recover from the current slump. These elements, plus state and local budget surpluses, form the Nation's savings pool.

Spending reduction will contribute to the recovery, and the recovery will contribute to deficit reduction. The deficit will fall as the economy advances, particularly if the recovery is a vigorous one. A strong recovery with 1-1/3 percent more real growth per year than in our forecast would bring the budget to near balance by 1988, provided we also curb the growth of Federal outlays.

However, if we fail to bring spending under control and if recovery is slow, we will face a deficit problem which is larger and longer-lasting than we can afford. In such case, the deficit could run in the range of 6 to 7 percent of GNP each year through 1988. Our tax reforms were designed to raise the private savings share, but still we would face the possibility of draining off a large part of the pool of savings, leaving less available for new capital formation. Interest rates could remain high, and the recovery could stall.

This Administration is determined that deficits of such magnitudes will not come to pass. We came to office with a program of boosting the rate of capital investment in order to place the economy on a faster growth track, and we will not allow ourselves to be diverted from that goal. We will take whatever measures are necessary to narrow the deficit to acceptable levels.

- Preferably, all of the necessary narrowing of the deficit would come from the outlay side. Total Federal spending represents the amount of resources absorbed by the government at the expense of the private sector. This spending can be financed by both taxes and borrowing, which in either case amounts to a drain on private resources. Only through spending reduction will the credit market find itself in a more favorable position.

- In the event that the combination of economic growth and outlay reductions is not sufficient to narrow the deficit to acceptable levels in the outyears, we are prepared to request additional revenue raising measures in those years. If the Congress chooses not to reduce spending, as we wish, then it is preferable to have the full cost of federal spending programs explicitly identified for the taxpayers who bear the burden of financing government If additional revenues are needed, this Administration will do its best to structure the tax code in a way that minimizes disincentives for productive effort.

Our Budget Proposals

Spending reduction is crucial. Unfortunately, it has been difficult to achieve because of the built-in momentum of Federal spending programs. Consequently, we are proposing strong medicine. None of us will find it agreeable, but it is critical to the restoration of vitality to our economy. There must be assurance that all will share in spending restraint, just as all of us will share in the benefits of a revitalized recovery. We, like a great many other nations in the world, have tried to live beyond our means. Now we must bring our spending into line with our productive capacity and strengthen the private sector which produces our national wealth.

The deficit reduction program that we propose contains four basic elements.

- The first is a freeze on 1984 outlays to the extent possible. Total outlays should be frozen in real terms in 1984. The 6-month freeze on COLAs, as recommended by the Social Security Commission, is to be extended to other indexed programs. There will be a 1-year freeze on pay and retirement of Federal workers, both civilian and military. Many workers in the private sector have accepted freezes in their pay. Federal workers can also make a sacrifice, which hopefully will serve as an example for sectors of the economy which have not yet recognized the need for moderation in wage demands. As a final item of freeze, outlays for a broad range of nonentitlement programs will be held at 1983 levels.
- The second element of our budgetary program contains measures to control the so-called "uncontrollables." Laws have been so written that Federal payments are automatic to all those declared eligible. We plan a careful review of all such programs, taking special care to protect those truly in need.
- The third element is a cutback of $55 billion in defense outlays from original plans.
- Fourth is a set of proposals involving the revenue side of the budget, described below.

We are projecting receipts for the current year (fiscal year 1983) of $597.5 billion. For fiscal year 1984 we expect receipts to be $659.7 billion. The 1983 figure represents a decline of $20.3 billion from the fiscal year 1982 total of $617.8 billion. This decline, and indeed the absence of an increase in receipts in the range of $50-70 billion, is due primarily to the recession. As I have already explained, our economic projections throughout the remainder of the recovery period are cautious. If real GNP grows at a faster rate than we have projected, then receipts for the current fiscal year, as well as for subsequent years, will be somewhat higher than we are now projecting.

In 1984, as the recovery is well underway, receipts are expected to rise to $659.7 billion, an increase over 1983 of $62.2 billion, representing an annual growth of 10.4 percent. This will occur as profit margins recover and other income shares continue to grow.

For the other years in our forecast period (1985-1988) we project an average annual growth rate of receipts about 10 percent without contingency taxes (and 11 percent per year including contingency taxes), with receipts reaching the $1 trillion mark for the first time in fiscal year 1988. All of these projections assume the legislative proposals included in the President's Fiscal Year 1984 Budget. Receipts under existing legislation will also grow, but at a somewhat lower 9-1/2 percent annual average rate.

The estimates of receipts made by the Congressional Budget Office reflect the higher real economic growth forecast by CBO in 1983 through 1985 and the somewhat lower growth thereafter. Thus far, CBO has published only baseline numbers, analogous to current services estimates without policy changes. As compared to the Administration current services projections, CBO estimates receipts to grow more quickly during the first 3 years of the period and more slowly during the latter three years, because of differences in projected rates of real economic growth. CBO's outlay estimates run below the Administration's throughout the period, mainly because of the difference in the basis for estimating defense spending. Therefore, on balance, CBO projects smaller baseline deficits than the Administration does on a current services basis.

It is noteworthy that under Administration proposals individual income tax receipts will continue to rise over the 1985-1988 period, but only as real income rises. Beginning in 1985, we will no longer collect hidden taxes in the form of bracket creep caused by inflation. Without the indexation provision of ERTA, individuals would pay $6 billion more in taxes during fiscal year 1985 alone, and about $100 billion more during the entire forecast period -- 1985 through 1988.

There has been a gradual upward trend in unified budget receipts as a percent of GNP, shown in the top line of Chart V. As shown in the bottom line of the chart, a major shift in the composition of receipts has been the rising share of social insurance and other payroll taxes to fund social security and other retirement benefits.

There is no proposed omnibus tax bill in the President's budget message. However, there are several separate tax items. Proposed tax legislation in the President's budget can be conveniently grouped under three broad headings: Proposals that improve the income security of Americans, proposals that will improve our ability to produce future output, and, as an insurance policy, a contingency or standby tax, which is intended as a clear signal that we will not permit spending to increase in the outyears unless we pay for it up front.

In the first category, our principal recommendation is for adoption of the bipartisan social security proposals. These proposals, which will increase receipts to the social security funds by $9.8 billion in fiscal year 1984, $11.6 billion in 1985, and $10.6 billion in 1986, are necessary to insure the solvency and security of these trust funds.

The second category, proposals to improve the utilization of our human resources, includes the tuition tax credit, the exclusion of earnings on savings for higher education, the jobs tax credit for hiring the long-term unemployed, and the enterprise zone tax incentives. These will all improve our production capacity, either through increased investments in education or, more directly, by getting our currently underutilized force of experienced workers back to work. As a group, these proposals will reduce taxes $0.5 billion in 1984, $1.2 billion in 1985, and $1.7 billion in 1986.

Finally, the President has proposed a contingency tax plan designed to raise revenues of about 1 percent of GNP in the event that, after Congress has adopted the spending reduction proposals, there is insufficient economic growth to reduce the deficit below 2-1/2 percent of GNP. The contingency tax plan would not go into effect on October 1, 1985, unless the economy is growing on July 1, 1985. The contingency tax plan is an insurance program. It is important to have a plan in place so that the country and the world know that we will not tolerate a string of deficits that would exceed 2-1/2 percent of GNP. Chart VI shows the effect on the deficit that the contingency tax would have if it were implemented. It also shows how the budget picture would be altered by stronger expansion such as some private forecasters expect. The deficit path under high growth reflects the assumption that real GNP increases 1-1/3 percentage points faster than in the official forecast path, starting with FY-1983. Such growth would be in line with the performance from the end of 1960 to late 1966.

The contingency tax plan would contain two elements, each raising about half of the revenues that may be required. One element would be a temporary surcharge of 5 percent on individuals and corporations. The other element would be a temporary excise tax on domestically produced and imported oil designed to raise revenues of about $5 per barrel. The contingency tax alternative shown in the budget raises $146 billion over the

36-month period beginning October 1, 1985. The specific contingency tax plan we will be sending to Congress for adoption this year will be designed to raise revenues of about $130-150 billion over a temporary period of up to 36 months.

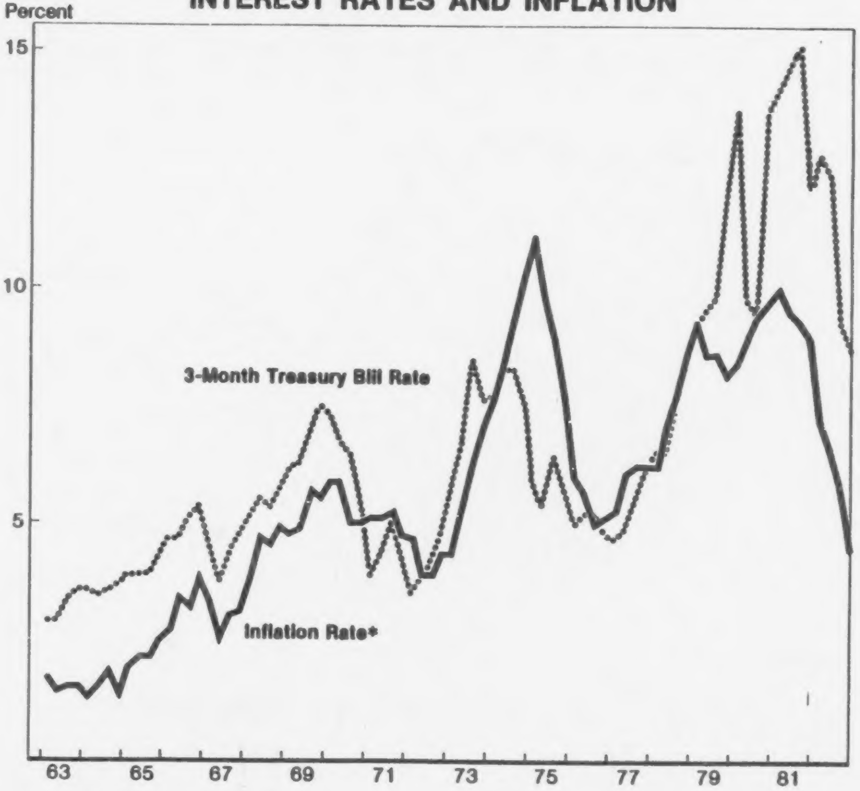
If these budget saving proposals are enacted, we will reduce the projected deficits by a total of $580 billion over the next five years, or by $2,400 for every man, woman, and child in the United States. The deficit as a share of GNP will be down to about 2-1/2 percent in 1988 from the 6-1/2 percent we expect this year. Total outlays will grow by only 7 percent per year in nominal terms over the next five years, compared with a bloated 13 percent between 1977 and 1981.

In addition, as part of our overall program, over the next year we will be taking a careful look at the entire structure of our tax system. We will be searching for ways to simplify the tax code and make it fairer while at the same time promoting economic growth by enhancing incentives for work effort, saving, and investment. This is the true road for putting people back to work and bringing the budget into balance.

We are confident that the deficit reduction program contained in this realistic budget is the right program for the economy at this critical juncture. The most important signals we can send the economy are spending restraint, deficit restraint, and a commitment to non-inflationary economic growth throughout the decade. This is the program we have devised. Together with the Congress, we can make it work.

Chart I

INTEREST RATES AND INFLATION



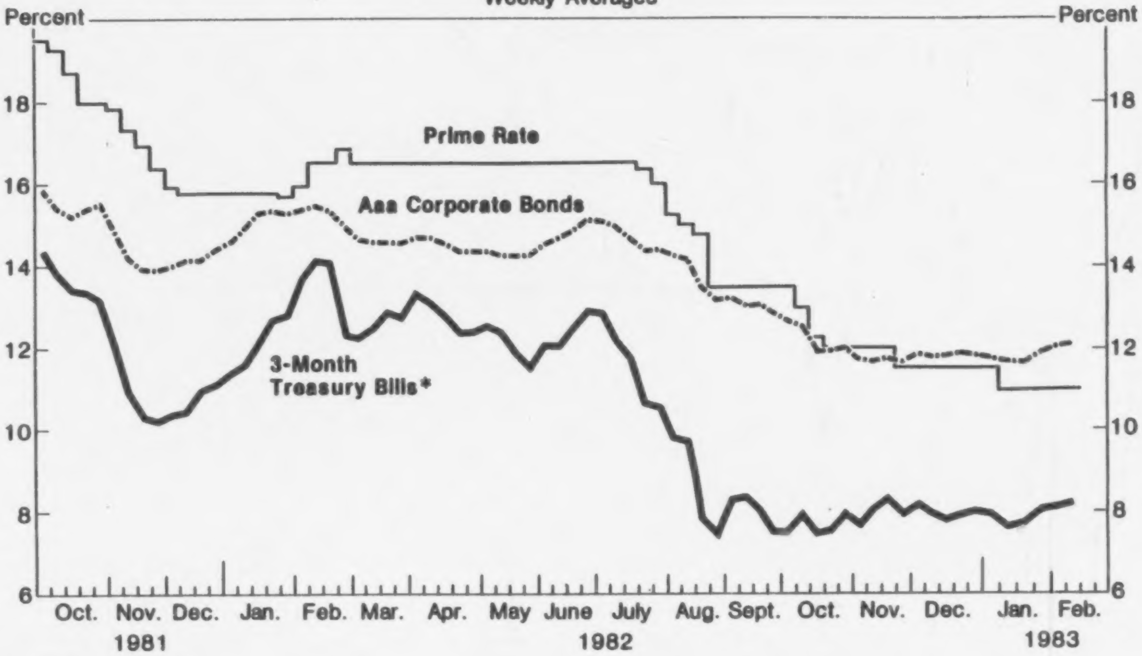
* Growth from year earlier in GNP deflator.
Plotted quarterly.

January 10, 1983 A30

Chart II

INTEREST RATES

Weekly Averages



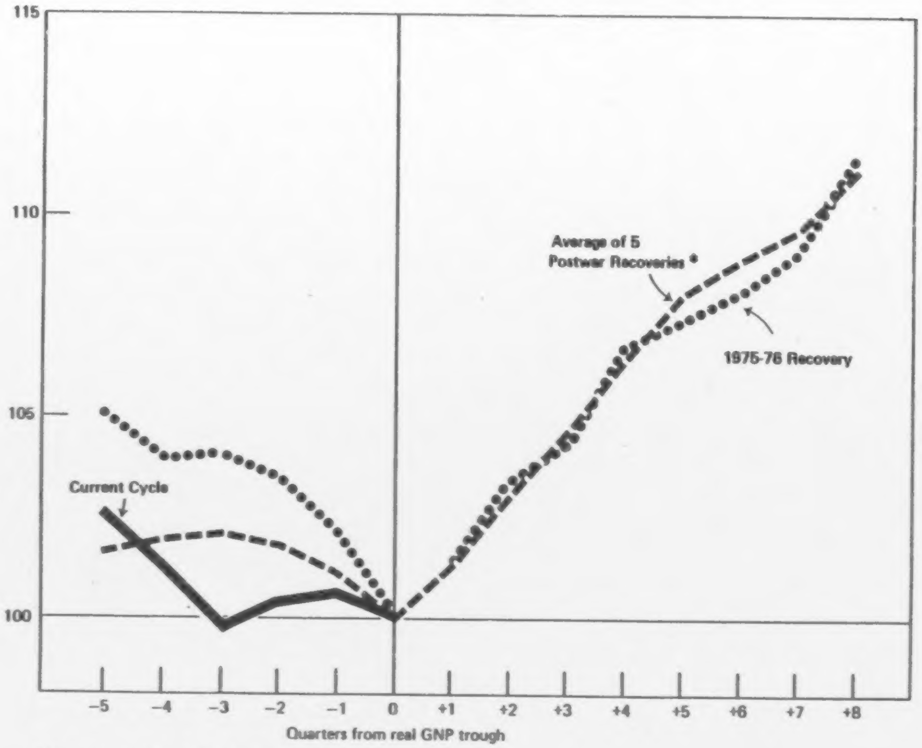
*Bank discount basis

February 14, 1983 A202

Chart III

THE PATH OF POSTWAR ECONOMIC RECOVERIES

Real GNP trough = 100

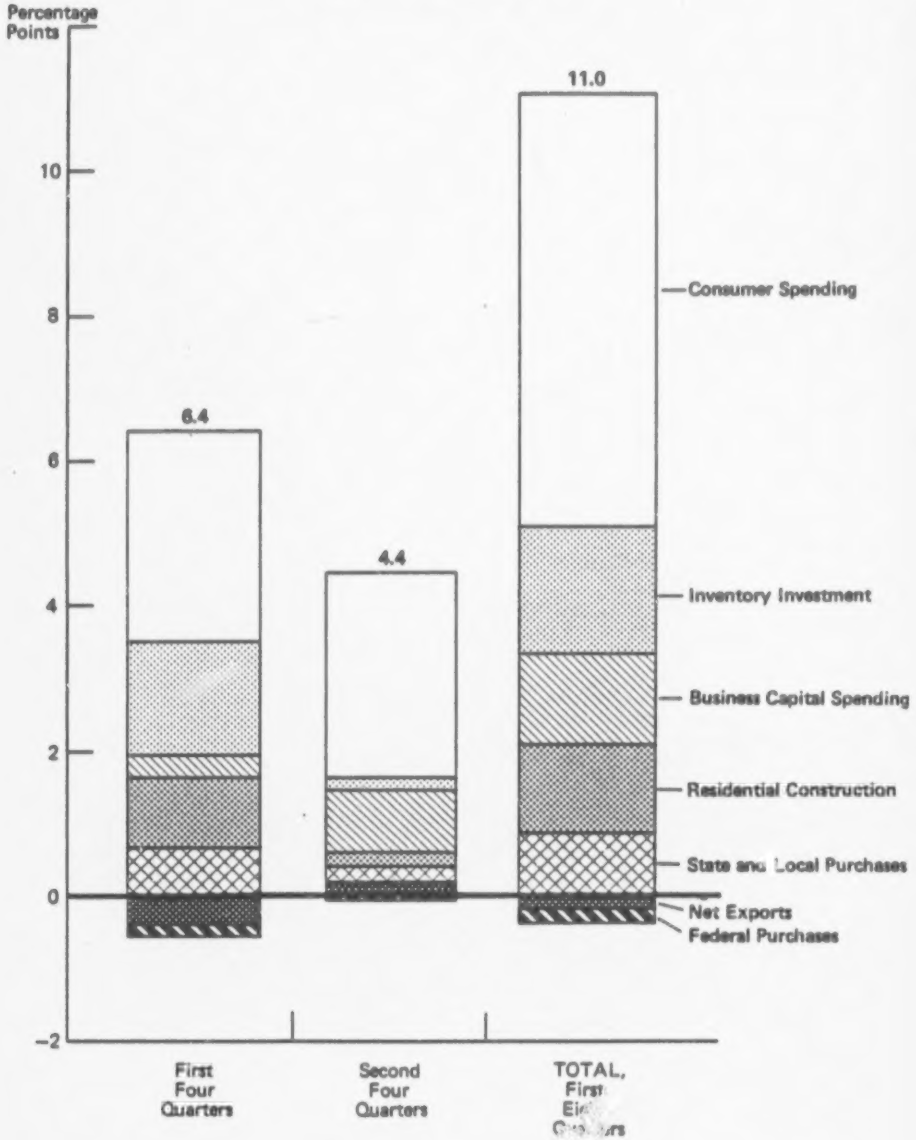


* Postwar recoveries excluding the Korean War period and the short-lived 1980-81 recovery.

January 25, 1983-A210

Chart IV

CONTRIBUTIONS TO A TYPICAL RECOVERY * BY REAL GNP COMPONENT



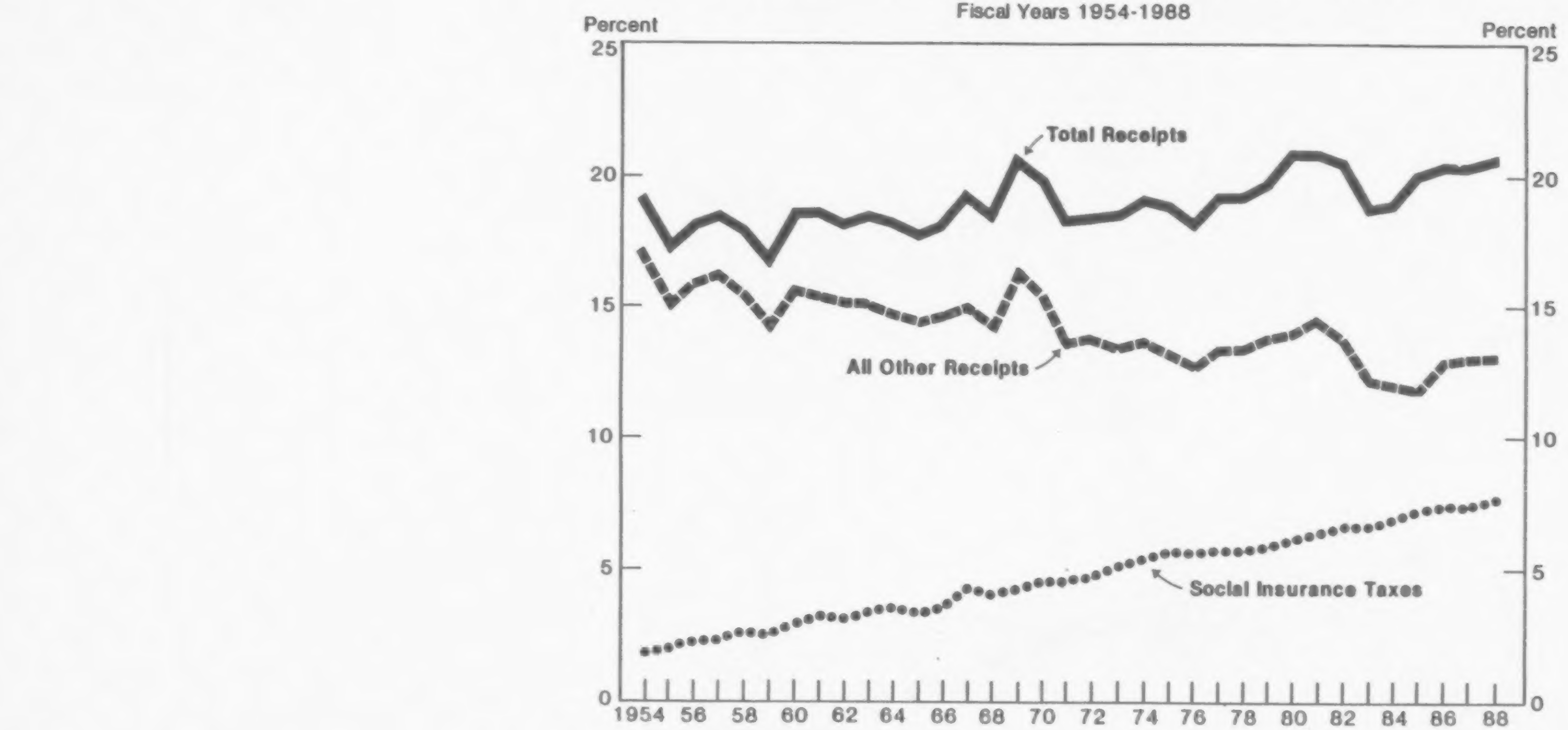
* Average of postwar recoveries, excluding the Korean W
and the short-lived 1980-81 recovery.

January 21, 1983-A213

Chart V

UNIFIED BUDGET RECEIPTS AS A PERCENT OF GNP *

Fiscal Years 1954-1988

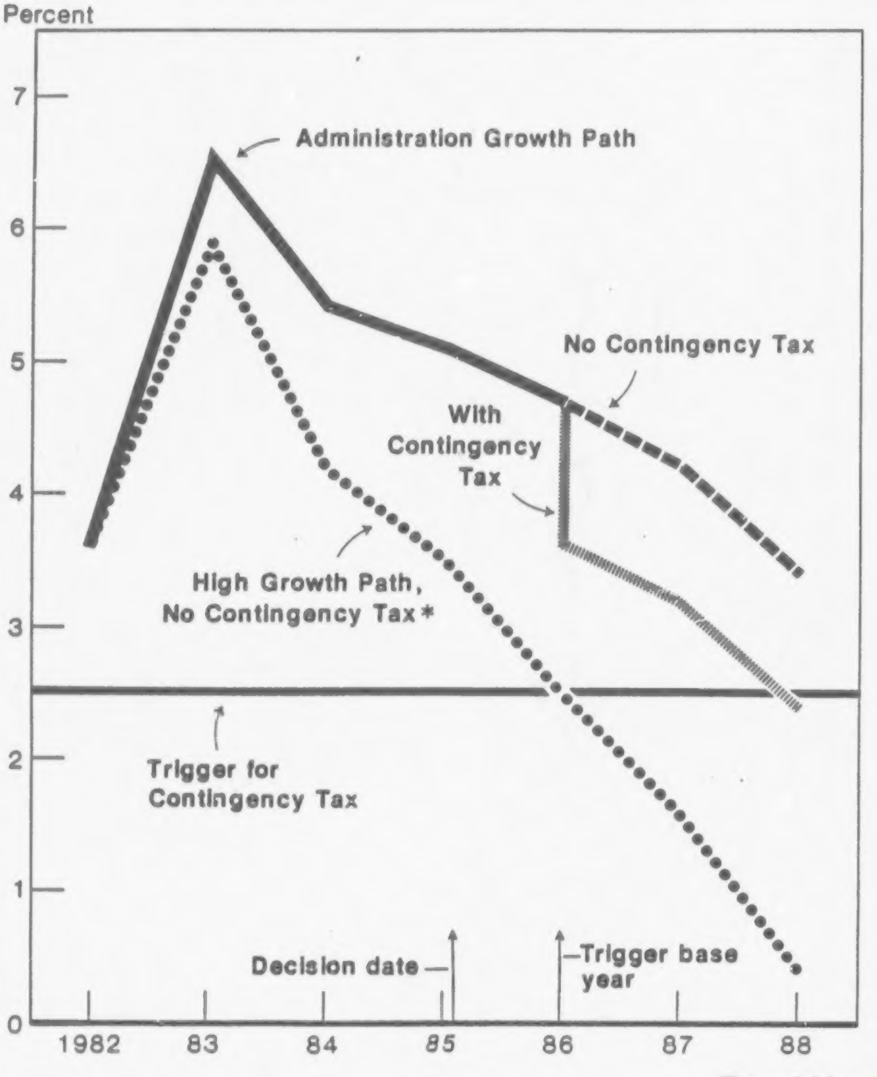


* Receipts include contingency taxes.

January 28, 1983-A215

Chart VI

THE DEFICIT AS A SHARE OF GNP



*Higher growth than the official path by 1-1/3 percentage point starting fiscal year 1983.

January 28, 1983-A214

MONETARY AND FISCAL POLICIES CAUSE RATES TO RISE

Chairman DOMENICI. Mr. Secretary, recently both long and short-term interest rates have risen about half a point. How do you explain that, and will the administration let interest rates continue to rise as this immediate past fact indicates?

Secretary REGAN. Right now, Mr. Chairman, the financial markets are worried about two main things. One is monetary policy, and the other is fiscal policy. Let me briefly describe the worries on each.

With regard to monetary policy, there is worry that since the weekly figures for December, January, and now February have come out, they show an unusual pattern of growth. M_1 and M_2 are rising by amounts that heretofore have preceded a very inflationary, reflationary type of economy.

As a result, people are worried that the Fed might have to really take severe measures to restrict the amount of monetary growth. If they were to do that, interest rates would go up. Accordingly, in anticipation of that, interest rates have turned up as you suggest in the last 4 or 5 weeks.

At the same time, the financial markets are worried about the very subject we are discussing this morning, the fiscal deficits. They are worried that we at Treasury are going to crowd out the private sector. We are borrowing this year to finance budget and off-budget deficits of at least $224 billion. Our forecast calls for a budget deficit of about $189 billion and an off-budget deficit of $14 billion next year and so on.

They are worried that as the recovery comes about that there will not be sufficient funds around. If there are not sufficient funds around, the price of money goes up. That is the old law of supply and demand.

So you have the two worries, monetary and fiscal, that has caused this most recent rise in interest rates.

MONETARY NUMBERS ARE CONFUSED

Chairman DOMENICI. Does that mean that you do not like the present monetary policy?

Secretary REGAN. Well, at the current moment, the Fed has told us that the monetary numbers that they regularly follow are very confused by the new financial instruments that the banks and thrifts are offering, the money market deposit account, the super NOW accounts and the like. This is causing a dramatic shift in the public's money preferences, one of the most dramatic shifts that has occurred in the history of our banking system. Well over $225 billion now—has shifted into the money market deposits accounts alone.

How to account for that and how much of the noise that is in the numbers is caused by this is unknown at the present time to the Fed. They are studying this very carefully. At the very moment that I am testifying here, Paul Volcker is trying to explain exactly what they intend to do about that to another committee.

What we have told the Fed is that we want a steady growth in the money supply. If we get that, and if the administration and the Congress work together on getting the path of the deficits down, this will reassure the markets that interest rates will come down. We are very concerned about this and we are monitoring it very closely. We want interest rates to come down.

Chairman DOMENICI. Let me ask you about your standby tax proposal.

You talked about everything that you thought was wrong with proposals: from the third year, the tax cut being deferred, to doing either deferring or doing away with indexing.

In the 1986 proposal, you asked for a $5 a barrel import fee on both domestic and foreign oil and you asked for a surtax. Would that be across the board?

Secretary REGAN. The surtax as we envisage it now, would be 5 percent of tax liability for both individuals and corporations. In other words, if you pay $200 in taxes, it would be an extra $10. If you pay $2,000 in taxes, it would be an extra $100.

ENACT STANDBY TAX OF 1 PERCENT OF GNP

Chairman DOMENICI. I understand the rationale of having a standby, and you know that this committee does not have any jurisdiction to make up the tax package that is recommended in the budget resolution, be it by targeting or by reconciliation.

I have had a little bit of difficulty as chairman of this committee understanding how we would condition the 1986 tax increase so that it is something that is statutorily sound. It does not have very much support, but maybe today you could explain to us how the administration would recommend that it be structured.

Secretary REGAN. Mr. Chairman, what we are suggesting is that no one, and I say again, no one, knows what is going to happen to our economy by the year 1985. But we do know, I think all of us are aware, that continued large Federal deficits, absorbing 3, 4, 5 percent of our gross national product, are much too high to continue year after year, and still hope for noninflationary or low inflationary economy.

Accordingly, we all recognize that we must do something about those deficits in the outyears. We could put an asterisk in the budget and say that future action would take place to reduce these deficits, either through spending decreases or a larger increase in gross national product than we are currently forecasting, or that there will be further tax increases enacted.

I am afraid, however, that that would not be believed in the money markets. Therefore, in order to be credible, we have suggested that after Congress has finished with the spending freezes and the budget cuts that we have suggested, that it then enact a standby tax which, if implemented, would raise revenue equivalent of 1 percent of gross national product.

Now, in those outyears our forecasts are calling for a gross national product of about $4,200 billion in 1986, rising to close to $5 trillion in 1988. One percent of that would be anywhere from $42 billion to $50 billion of additional taxes. The tax increases would be triggered if the economy were not performing as well as we think, if the spending cuts have not been enacted and the resulting deficits look to be more than 2½ percent of GNP for fiscal 1986, which begins, as you know, on October 1, 1985. We think that such a plan would give assurance to the money markets that the Congress and the administration are sincere in their efforts to get these deficits down and that they are not just promising something that they will never deliver on.

FREEZES MUST BE IN PLACE BEFORE CONTINGENCY TAX ENACTMENT

Chairman DOMENICI. Well, one of the reasons that you oppose indexing is that it permits the Congress to finance deficits. Without it, it permits it to fund deficits on bracket creep or inflationary add-ons to the tax base.

In your explanation of the surtax, unless I have misunderstood you, you said if Congress did not make the requisite cuts, or if the Congress—or the economy did not perform adequately, the deficit would be larger than 2½ percent of GNP. Is that not just as much an invitation not to restrain, as the invitation that you and others envision comes with nonindex of bracket creep?

Secretary REGAN. Well, our suggestion for the contingency tax contains the provison that the cuts must be made first, that is, the freezes that we are suggesting for 1984 must be in place before contingency tax legislation would be sent up to the Hill. So that——

Chairman DOMENICI. So it is not based upon us not doing it, but rather that we do have the——

Secretary REGAN. You do it, and then we would send the suggestions up.

Chairman DOMENICI. How would anyone know in 1986 whether we did that or not? Who is going to say it?

Secretary REGAN. Well, we would send it up for enactment this year, Senator, so that we would know whether or not you had enacted at least the 1984 freezes, and if you enact these 1984 freezes, the budget effects of those will definitely show up in those outyears.

Chairman DOMENICI. I do not know how we draw that kind of budget resolution, but I guess that is up to us.

Senator Chiles?

CONTINGENCY TAX MAY NOT BE NEEDED

Senator CHILES. Mr. Secretary, we used to have a theory that we tried to work around here, that if you could make some spending cuts, you could then offer a tax cut. We used to call that Nunn, Chiles, Bellmon, Domenici, Johnston, Biden, and everyone else was a part of it.

The inducement was there—or what you are saying was that Congress loves to make tax cuts. You had to make those spending cuts before you could make the tax cut.

Now, you are reversing that, and you are saying that you have to make spending cuts so that you can have a tax increase. That is not much of an inducement to Congress. You have to cut spending so that you will get the opportunity to raise taxes.

Secretary REGAN. May I explain that, Senator?

Senator CHILES. That is a drastic reversal.

Secretary REGAN. We are looking at the size of the deficit. In the past deficits were held down to less than 3 percent of gross national product. Even with the spending freezes that we are suggesting, and the other cuts that we are suggesting in this budget, the deficit as a percentage of GNP will still be well above that until 1988—may I have that chart—as we indicated——

Senator CHILES. I understand that very well.

Secretary REGAN. What we are saying is that we, not you, but we should bring these deficits down as a percentage of GNP. You can see where they are here in 1983, they are above 6 percent. That is much higher than any of the industrial nations of the world have.

Now, how are we going to get those down? Cuts. But if we stay on the path, without the contingency tax cut we do not get below 3 percent. What we are saying is that we should get near below 3 percent at least in the outyears. And that is why the contingency tax is proposed.

Now, if you cut more you would not need that contingency tax.

Senator CHILES. You put so many conditions on the the cut. If you are talking about something that you expect to be a believable market, there has got to be something that the market can have some opportunity to believe in.

Would you say we have to be in this kind of recovery; we have got to have the kind of spending cuts, we have got to have all of that, I do not know how the market is going to believe it.

What I really want——

Secretary REGAN. It is really not that complicated.

GET THE DEFICITS DOWN

Senator CHILES. Well, what I really want to ask you, Mr. Secretary, is given the fact that the contingency tax cut was sort of pronounced DOA in its arrival in Congress, in other words, it was stillborn, it never did draw a breath, what are you going to come up with now? What are we going to tell the markets now? Because I think this half-percent increase that you are seeing in the loan rate, the market rate is already a sign that the market is judging what everyone else is judging around here, that the contingency tax plan is not going to fly. So they are already looking at those very same deficits which you have pointed out how horrible they are—what are we going to do now, and can we wait until 1986, given the size of that?

Secretary REGAN. There are several answers to that.

First of all, if the contingency tax is not enacted, and the deficits remain high, you must expect higher inflation, higher rates of interest, and a very weak economic recovery, and again a recession.

In other words, the same type of situation we have experienced. What we think is that the Congress and the administration should exercise fiscal responsibility and work somehow to get the deficits down.

Now, if you do not like the contingency tax, if you do not go with that, you are saying that you agree that we should have further large deficits in the out years.

Senator CHILES. No, sir. No, sir. I think we are saying that we agree there should be additional revenue, but that revenue: one, should not wait until 1986; and two, it cannot be a cockamammy thing like the contingency tax. It has to be something that the market can believe.

Secretary REGAN. Well, let us talk about the "cockamammy tax," as you put it, for a moment.

As far as taxing in 1983, certainly you would not suggest raising taxes just as we emerge from an economic recovery.

Senator CHILES. No, sir, I certainly would not. But I also would not suggest, at a time that you have got a $200 billion deficit, that you would cut taxes on a permanent basis, I have not been able to find anybody who has answered who would tell me they would suggest a permanent tax cut at a time that you have a $200 billion deficit.

You just pointed out the terrible figures on those charts, and yet that is what you are suggesting we do when we allow the third year of the tax cut to go into effect, which is cutting taxes, not raising taxes. That is cutting taxes.

EQUITY PROBLEM COULD ARISE FROM REPEAL

Secretary REGAN. May I quote to you from Alice Rivlin, who is the Congressional Budget Office Director, on this? And I quote her:

> Repeal of the third year of the tax cut could prolong the current recession, or dampen any recovery. Had the tax legislation of 1981 and 1982 not been enacted, all else being equal, a large fraction of the projected deficits would not have appeared. But that would have required taxpayers to shoulder a lax load of nearly 23 percent of gross national product. Much more than in any postwar year.

And, she further says that, "an equity problem could arise from repeal of the third year cut, and the like."

Senator CHILES. Yes, sir. I read that, and I asked her a little question on that yesterday, and the question I asked was, would she, if she was starting off, facing a $200 billion deficit, recommend, as an economist, a permanent tax cut, a further permanent tax cut, facing this deficit. And she did not say that she could recommend that.

Secretary REGAN. Well, from the point of view of how to achieve recovery, how are you going to get the savings pool necessary for investment in housing, on new machinery, or anything else? You have to have savings. You certainly do not get savings by raising taxes, because your are taking the very money away that would, in part, be saved.

You also want—the traditional remedy has been to increase consumption. You do not increase consumption by taxing people. You increase consumption by letting them have their own money to spend.

Senator CHILES. Mr. Secretary, we both agree that we have got to tax people. We have already established that, we are just talking about the price now. We have already established what our profession is. We are talking about the price now, and the question is whether you are going to wait until 1986, and whether you are going to come up with, in my version, the cockamammy thing, or whether you are going to do something that the markets can read as a signal now, and say they are serious about trying to get this deficit down.

INCREASING TAXES COULD ABORT RECOVERY

Secretary **Regan**. Well, what I am trying to say is that if you increase taxes right now, the market will look at that as even worse, because you would abort the recovery right now.

Senator **Chiles**. Well, I think if we cut taxes right now, which we are getting ready to do, the market is going to look at that and say what in the world are they doing adding to this deficit at a period when we already have these large deficits.

Secretary **Regan**. Well, may I say in reply to that, that we did increase taxes, not by legislative means, but by inflation, during the seventies, and budget deficits continued to grow.

You did not—you did not cut——

Senator **Chiles**. Well, what kind of deficits, Mr. Secretary? What size? What percentage of GNP did the deficits grow to be, and were they not cyclical deficits, as opposed to structural?

Secretary **Regan**. They were not cyclical. In the recovery years of 1977, 1978, and 1979.

Senator **Chiles**. Maybe not in recovery years.

Secretary **Regan**. And they amounted to something in the neighborhood of 2 percent of gross national product.

What we are saying is that the proper way to do this is to cut Federal spending in order to get deficits down, not raise taxes.

SWITCH IN PRIORITIES

Senator **Chiles**. But, Mr. Secretary, in your own budget proposals that you propose to us, you are not talking about cutting spending. What you are about is a switch in priorities. We cut 1.2 percent of the GNP in 1981 off of spending, and turned around and raised 1.4 of GNP in Defense. So we did not cut spending, we just reallocated some moneys. That was your request.

Secretary **Regan**. Well, under our proposal, the spending, as a percentage of GNP, is reduced from the current over 24 percent to where it is, 23 percent of GNP.

Senator **Chiles**. But even with that, we are looking at this over a four-percent gap if we do not come up with revenue.

Secretary **Regan**. No, we could cut spending further. There is no——

Senator **Chiles**. Could you suggest where?

Secretary **Regan**. I think that this administration would be willing to work with this committee, and with the Congress, to make further cuts, if that is feasible.

Chairman **Domenici**. Senator Kasten?

Senator **Kasten**. Thank you, Mr. Chairman.

Mr. Secretary, we can respond to these questions, as you did earlier, be declaring that the basic assumptions the administration uses are way off base. We are not creating these large structural deficits that people are talking about. We should argue the other side of the question.

Just a minute ago you talked about the importance of increasing the savings pool. As you well know, we cannot increase savings by taxation.

I would like to read to you a couple of letters from Wisconsin, because there is a misconception that this whole idea of the new withholding on savings and dividends is being ginned up by some of the thrift institutions.

Let me just read you one or two letters.

> Dear sir: I am a widow, 73 years of age. My husband and I were married during the Great Depression. We knew how it felt to do without, to suffer hunger, yet never once did we ask for any help. We reared four children, four wonderful children, who had to pitch in and help earn money toward their education. Six years ago my husband died. By careful living, and denying ourselves things many might consider essential, we finally had a few dollars in the bank. I had hoped the interest realized on that investment would help ease the financial burden of the few years ahead for me. Now there are those who support legislation to take away a goodly percentage of even that. For shame. I will continue teaching my piano class, raising the few vegetables that I can in my little garden, mowing my lawn myself, in the winter shoveling the snow from the walks myself, and after there is no more strength to do these things, then what. Will the same Government that taketh away, give? If so, it will be at a terrible expense to its people. God Bless America, may God grant her legislators who are truly mindful of the needs of the people of our beloved Nation. Mildred O. Meyer. Jefferson, Wisconsin.

Senator **BIDEN**. Is she for you or against him?

Senator **KASTEN**. She is for me, and against him.

90 PERCENT OF TAXPAYERS ARE EXEMPT

Secretary **REGAN**. Senator, may I ask you a question?

You said that she is 73 years old. Ninety percent of all American taxpayers over the age of 65 are exempt.

Senator **KASTEN**. I cannot tell whether she meets that exemption or not.

Secretary **REGAN**. If she paid taxes this year of $1,500 or less, she is exempt.

My point is that this has not been explained to her by banks properly; that she is being misled by propaganda into thinking that she will have to do this.

Senator **KASTEN**. Mr. Secretary, I think you are absolutely wrong. Being exempt from the tax does not in any way mean that she is exempt from the problem that we are in the process of creating with withholding.

Secretary **REGAN**. She will not have to have anything withheld from her dividends, Senator, or her interest.

Senator **KASTEN**. If she fits under that threshold. I cannot tell from the letter what she considers modest savings and whether if she is going to fall above or below that $1,500.

Secretary **REGAN**. If she has $10,000 in savings and that institution is paying her 9 percent, and they do have to withhold—which means that she is paying more than $1,500 a year in taxes—then the net interest rate for her has only been reduced to 8.95 percent. The true cost to her is only $5 on $10,000, and I do not think that that is really that upsetting, if it is properly explained to the woman.

Senator **KASTEN**. Whether she is above or below that minimum threshold, she is not exempt from the problem. The problem is that half of all accounts will be subject to an exemption, and the IRS will have to process these 200 million forms. Do you have them ready to go already? Is this why we included the hiring of the 5,000 new IRS agents in the tax bill, is it?

EXEMPT-FORMS SIMPLE TO FILL OUT

Secretary **Regan**. The forms are made up with our permission by the banks themselves. It will be no more difficult than filling out a deposit slip. You put your name, your address, your social security number, and whether or not you are exempt. Just check a box. That is all that has to be done. The bank keeps that on file. They do not send us forms.

Senator **Kasten**. Is there not such a thing as a form W-6 that the IRS is in the process of putting out that was supposed to be out February 1 available for taxpayers to file exemptions?

Secretary **Regan**. That is what I am talking about.

Senator **Kasten**. No; you are not. There are two different ways of doing it. The bank can make out their own form, and you have got a W-6 form which is a Government form, is that correct?

Secretary **Regan**. It is either or. We have given the bank and the customer the permission to use either form.

Now, if the bank merely has this, they can print it on a 3 by 5 card. It is not that difficult.

Senator **Kasten**. The American Association of Retired Persons is opposed to this basically. This conversation right here is confusing. You are going to say that you can have a billion different kinds of forms coming in, each bank, each savings and loan, each investment group is going to make up their own form, hand it to their people, the people put the stamp on and they send it in here?

Secretary **Regan**. No, no. They do not send it in. They send it to the bank and then the bank, when putting its software in, does not include her bank account as one of the ones in which they deduct. This is a simple software problem and very easy to accomplish in any bank that has even a small computer.

Senator **Kasten**. Then you are putting the bank in the position of being the collection agent for the IRS.

Secretary **Regan**. That is exactly the point, and they already are. They withhold on their employees, wages right now and they collect that and send it in.

Senator **Kasten**. And they are also sending in a 1099 form.

Why do you not match up the information——

Secretary **Regan**. We are doing away with all 1099's.

Senator **Kasten**. Why do you not match up the information that you already have rather than create this whole new set of problems? The 1099 form is in existence, it is being sent in, it ought to be matched up.

TAXES NOT BEING COLLECTED ON $20 BILLION

Secretary **Regan**. And we know that there is noncompliance with it. That is what I explained last year when working with the tax writing committees. In test after test at the IRS, we have found that there are $20 billion of interest and dividends that we are not collecting taxes on. By withholding, we think we will collect taxes on at least $4 or $5 billion of that. We are not asking people who do not owe the tax to pay. We are not asking the people to do anything different by than they are already doing except to signify to the bank whether they are exempt or not.

Senator KASTEN. Treasury figures show that you have 90 percent compliance—10 percent noncompliance. There is a 1981 IRS study that shows 97 percent compliance with an improved information reporting system.

You just put out the figure of $20 billion. That is your estimate from last year. This year you are using a figure of $26 billion for the revenue loss from repeal of withholding.

Secretary REGAN. I was referring to when we——

Senator KASTEN. Your February 8 letter has kicked it up. In your February 8 letter, you show that withholding will bring in $26 billion in revenue. Last summer you told us that withholding would bring in $20 billion over the same period of time.

Now, interest and tax rates have both gone down. How are you going to pick up more money this year than you would have last year?

Secretary REGAN. The savings pool has increased.

Senator KASTEN. The what?

SAVINGS POOL INCREASES

Secretary REGAN. The savings pool has increased dramatically since our figures now go through 1988.

Senator KASTEN. And so there are dramatically more cheaters.

Secretary REGAN. No; there is dramatically more to be collected.

Senator KASTEN. You mean that you are going to get float.

Secretary REGAN. We just took the same percentages and applied it to the new amount of savings, Now, as far as that study is concerned, that is a 1977 study that said if everything were perfect, that is all if the names came in correctly, no misspellings, no misspelling of address, every social security number correct, and then we were to match up perfectly, we would be able to accomplish that. I submit that that is not feasible.

Senator KASTEN. Do you not feel that a new 10-percent withholding is going to be a disincentive for savings?

Secretary REGAN. No, absolutely not. People are going to——

Senator KASTEN. You are going from $20 to $26 billion, and assuming a new regulation on savings.

Secretary REGAN. What you are saying, Senator, is that if we go with complicity in tax evasion, that we will encourage savings. We disagree with that. Savers know that they are supposed to pay taxes on that now. All we are asking them to do is to pay their taxes.

Senator KASTEN. My time is expiring. I just wanted to ask one other question.

Chairman DOMENICI. It has expired.

Senator BIDEN. I will lend you some of mine.

Secretary REGAN. Thanks a lot.

BANKS NOT BEING BLACKMAILED

Senator KASTEN. Mr. Secretary, my question is based on the article here that says the chairman of the Senate Finance Committee and the Secretary of the Treasury threaten banks with higher taxes.

Are you blackmailing and threatening the banks?

Secretary **Regan**. Absolutely not. I deny that we are threatening the banks and I deny that we ever threatened the banks.

Senator **Kasten**. So this story in the Washington Post——

Secretary **Regan**. I answered a question that a Senator of the United States asked me when I was sitting in the witness chair. I cannot tell you how a reporter came to that conclusion. I was asked, in conclusion, do banks pay taxes? I said very little. And the truth of the matter is they pay less than 10 percent of their earnings in taxes. That is their effective tax rate.

I was then asked by the same Senator as to whether or not there were methods of taxing banks? As Secretary of the Treasury, I had a duty to answer that, and I answered, yes, sir, there are many ways we tax banks, and I showed him at least two or three ways that banks could be taxed.

Senator **Kasten**. Well, I am pleased with your answer. That was not the way it was reported.

Secretary **Regan**. I cannot help it. I did not write the story. But if you look at the record, you will find that is exactly how it happened.

Senator **Kasten**. Thank you, Mr. Chairman.

Chairman **Domenici**. Senator Biden.

Senator **Biden**. Now to the easy part.

Secretary **Regan**. That was easy.

Senator **Biden**. While we are talking about newspaper articles, I was interested in your answer on banks. One of the things I would like to know is, I guess, is it yesterday's or today's Times—in today's New York Times, you are quoted as saying:

> I think a third one being very candid is—regarding interest rates is bank earnings. I think that banks faced with a lot of problem loans, both domestic and international, are doing their utmost to keep their earnings up by keeping their interest rates up.

Is that correct?

THREE CONDITIONS KEEPING INTEREST RATES UP

Secretary **Regan**. There were three conditions that I said were keeping interest rates up. The first was monetary, which I have already explained to Senator Domenici. There is fiscal policy. I said the third one, being candid, was that banks always on the way down are very reluctant to cut rates when they do not have to. Money market pressures are such at the present time that banks do not have to cut rates.

Senator **Biden**. So the roughly 7 percent real interest that they are collecting right now, at least a portion of that is because they are covering bad loans and it is a profit motive, It is not merely what we have all been talking about, the risk factor. There is nothing wrong with that. I just want to know.

Secretary **Regan**. That is what I was going to say, there is nothing wrong with a profit motive being expressed by bankers. You would expect bankers to be bankers.

Senator **Biden**. I expect bankers to be bankers, and I guess I expect human nature to be human nature.

But at any rate, let me get to my concern. You know, we with all due respect, and I am not being facetious to the Senator from Wisconsin, and to many of the questions I have also asked you in past years and other witnesses in the past 5 or 6 years, I am beginning to wonder whether or not we have, myself included, whether we have any notion of what is happening in the economy.

Back in 1980, Carter came along and said that we are going to have a surplus of $16.5 billion in 1981, and both the House and Senate passed balanced budgets. You—and I will not go through the litany of your predictions and the administration's predictions. Here we are now with a situation where we all acknowledge that we have a serious problem regardless of your charts or any other charts put up. We all know, as they say in the east side of Wilmington, Del., we are in a world of hurt. And deficits are staggering. Alice Rivlin's testimony before the Appropriations Committee, I guess today, had a chart which talked about "The Budqet Outlook Under Administration Policies" by fiscal year in billions of dollars. She shows that the CBO estimate of the deficits under the President's policies, will be slightly lower than your estimates in 1983, 1984, and 1985, and 1 billion in 1986, but then they start to get higher in 1987 and 1988. And that assumes your standby tax is in place.

GETTING CONFLICTING SIGNALS

So, once again, we nonprofessional economists sit up here, at least me, and are getting a number of very, very conflicting signals about what it is going to look like in the outyear.

We all agree that there is a need for additional tax revenue, and my question as it relates to the standby tax is—and I may be wrong on this, and please correct me if I am—the amount of revenue that would be saved the Federal Treasury by not going forward with indexing on schedule is relatively close to the amount of revenue that would be raised by the standby tax if conditions warranted it. Is that correct?

Secretary **Regan**. That is approximately correct. Let me see. Yes. They are roughly in the same ball park. The contingency tax would raise somewhat more revenue than would be saved by not going ahead with indexing.

Senator **Biden**. Now, I am being serious when I say this, Mr. Secretary, on the question of whether or not it is believable that a standby 1986 tax would go in place, I am not sure, and you certainly know the people in the financial community better than I, but I would suspect that they are at least wondering, although they may be hoping that the President is reelected, they at least acknowledge that maybe there will not be a Republican President, maybe—or maybe there will be a Republican President and a different Republican President, that is a possibility, and that a prudent person would have to at least calculate into their thinking, and if that is the case, maybe whomever is President would not agree to the same mechanism by which the standby tax would be collected. Is it not just a lot simpler to make the indexing contingent? Why do we not just say exactly what you said, the circumstances under which the standby tax would take effect would, instead of triggering a standby tax, would trigger a delay in indexing? Why do we not do that? Is that not just a lot simpler, it is not additional taxation, it does not go to the savings argument that you are making because we are talking about new revenues anyway; it does not deal with the third year of the tax cut. I mean why do we not do that? I really fail to understand that.

5-YEAR PROJECTIONS NOTORIOUSLY OFF THE WALL

Secretary REGAN. All right. Let me take a swing at that one, Senator.

First of all, with regard to your question as to where we are going in the economy and the like, we are required, as you know, by law to make these 5-year projections.

Senator BIDEN. I understand that.

Secretary REGAN. Five-year projections are notoriously off the wall because no one knows for sure what is going to happen next year, let alone in a 5-year projection. Frankly what we have done is to straightline for the years 1985, 1986, 1987, and 1988 what we have forecast for the 1984 period. That is more of a projection than a forecast.

As a result of that as opposed to what the CBO did, they came in with figures higher than us and they brought their figures down in the outyears. Either one of us could be correct or neither of us could be correct. No one knows. That is where the difference comes as far as how the deficits are in those outyears are arrived at.

As far as indexing is concerned, this is a matter of philosophy I think more than anything else. If indexing is put in for taxes, this means that there will not be the availability of funds year after year by any self-induced inflation on the part of the administration.

DELAY INDEXING

Senator BIDEN. Since my time is short, Mr. Secretary—I understand the philosophy but we both understand the conditions upon which your standby tax would take effect. We are not going to be in that kind of period, otherwise your standby tax does not take effect. We are not jettisoning the philosophy. It seems to me it is just prudent to say that we will delay, not eliminate. I mean I do not think anybody here is proposing, if the economy is as it is now, would propose tax reductions to be initiated and take effect this year. I doubt whether you would be sitting there agreeing with the notion even though philosophically I know you agree with it.

I mean I think we are just getting so hard up here, we Democrats on the one side talking about jobs programs and about cutting defense and you Republicans, you the administration hanging the country up on ideology. I think it is time we got rid of all of this, being so hung up on our ideological predisposition and look at a simple basic pragmatic approach. Do not eliminate indexing, which I think we should, but do not eliminate it, just delay it. So the same conditions upon which your standby tax takes effect, indexing is delayed. That is believable out there in the market. Nothing you are going to be able to do, in another administration, could possibly be believable. That is the only thing we can do for sure.

My time is up. I really hope you consider it because we do not have much more time, it seems to me, in this Congress, and the relationship between the Congress and the administration to continue to dally in what I believe to be is our—both our ideological excesses here. Let us get practical and do something that somebody can believe.

But my time is up and I will stop.

Chairman **Domenici**. Thank you, Senator.

Senator Gorton?

PROJECTED RATE OF GROWTH IS CONCEIVABLE

Senator **Gorton**. Mr. Secretary, I believe that in an answer to Senator Biden, you stated that the 4 percent real GNP growth in the far out years was simply a straight line projection, rather than a prediction.

Do you believe that kind of steady and sustained growth is consistent or inconsistent with the kind of budget deficits which are also projected in the out years in the budget?

Secretary **Regan**. Well, if we have a straight line average of 4 percent, that would accommodate a year of 5, and a year of 3, or perhaps even a year of 6 and——

Senator **Gorton**. No, that is not really my question.

Secretary **Regan**. That is what I am coming to.

Senator **Gorton**. Can we have that kind of growth, even on an average basis, with budget deficits as large as we have projected?

Secretary **Regan**. Yes, it is conceivable that we could have that rate of growth, and these deficits, as long as they are trending down, Senator, which is what the money markets want to see, and if we could keep them down in the—well, we would prefer to see less than 2½ percent of GNP. As long as they are coming down toward that, that is reassuring to the markets.

What is anathema to the markets would be if those deficits trend down for a short period of time and then turn back up to the 5 or 6 percent area, that would really kill growth.

Senator **Gorton**. What percent of the GNP will revenue collections represent in 1984 under your budget?

Secretary **Regan**. I think it is around 18.9 or 19 percent; 18.9 I am told.

Senator **Gorton**. Are they likely, under your projections, without any changes, other than those that are recommended in your budget, to exceed this 20 percent at any point in the future?

Secretary **Regan**. I think they go just to the 20 area, out in the 1986-87 area. But they do not go above 21 percent.

Senator **Gorton**. Do you think it realistic, or even advisable, to project the time in the future that you can foresee in which Federal spending will be no more than 20 percent of gross national product?

Secretary **Regan**. No, I do not.

CUT SPENDING AND INCREASE REVENUES

Senator **Gorton**. Then you get right back to the point that Senator Biden raised, did you not? We just cannot get from here to there, unless we both cut spending and increase revenues.

Secretary REGAN. I think that we can increase revenues, but the proper way to increase revenues is through a greater growth in the gross national product.

Senator GORTON. That does not increase as a percentage of the gross national product.

Secretary REGAN. Even with indexing for inflation, real economic growth will, with our progressive tax structure, increase revenues as a percent of GNP. We can have more revenue, and as we get more revenue we do not have to allow spending to meet that revenue. If we keep spending coming down as revenues rise——

Senator GORTON. I could not agree with you more. But I do not believe that that is consistent with your answer to my last question, that we are never going to get spending down to 20 percent.

Secretary REGAN. Well, what I am saying is, it is theoretically possible to get it down there, and it could come down there if we hold spending level as the gross national product increases.

What I despair of is the fact that as revenues increase, history has taught us that Federal spending rises to meet those revenues, and in fact in most years it goes beyond them. But it is theoretically possible.

FREEZE ON COLA'S POSSIBLE

Senator GORTON. Do you anticipate that in the next couple of years you are going to be recommending additional freezes on cost of living adjustments in order to keep that spending percentage down?

Secretary REGAN. That would depend upon the rate of inflation. Actually if we could get inflation down to where it is 3 percent, 3½ percent, or less, I would recommend that, yes.

Senator GORTON. You would recommend it?

Secretary REGAN. Yes. Because I think that if we are successful in getting inflation down there, automatically social security would not get an increase, and I would propose the same thing for the others.

Senator GORTON. Well, on the contrary, automatically social security would.

Secretary REGAN. No, if it is less than 3 percent, they do not get a COLA.

Senator GORTON. But you have to have inflation at less than 3 percent for that to take place.

Secretary REGAN. That is correct.

Senator GORTON. Do you project an inflation rate of less than 3 percent in any year that you can see?

Secretary REGAN. We have not, but again it is entirely possible. There are many economists who are saying we will have less than 3 percent this year. We do not think so, but there are many who are projecting that.

Senator GORTON. Do you believe that it is even remotely possible to get the kind of domestic spending cut priorities that you have outlined in your budget, without subjecting the Defense budget to any cuts, other than that which the administration has agreed? Do you believe it would be fair to do so?

Secretary **Regan**. Well, as you know, I am really not an authority in this area, I am Secretary of the Treasury, rather than Secretary of Defense, and I go along with the budget that the Commander in Chief, and that the Secretary of Defense say is needed.

Senator **Gorton**. That is an eloquent answer.

Thank you, Mr. Chairman.

Chairman **Domenici**. It is the only one—the only answer that you could expect, is that not correct?

Senator Johnston?

Senator **Johnston**. Thank you, Mr. Chairman.

Mr. Secretary, I met with the President and you, and a group of Senators in the Cabinet Room in the spring of 1981, when the selling of the tax program was before us, and I asked a question of the President at that time: "Why should we not have a linkage between the performance of the economy in the second and third year of the tax cut?"

I remember very clearly that you chimed in and talked about the expectations of the market, Wall Street, with all that conjures up in our mind—the gnomes on Wall Street who control this thing with the various strings that are also mysterious—and it was at least an answer that we could identify with. But it so happens that it did not work out.

Now, those money markets, those managers, those gnomes, those controllers of Wall Street, appear to be on the other side. Indeed, just the other day I saw where former Secretaries Pete Peterson, John Connolly, Bill Simon, and a host of others, and those from the Fortune 500, and others, joined together in what I regard as an absolutely astonishing ad, in which they take this administration and its policies on directly, head on, and say that if we do not get this deficit down by $175 billion by 1985, by tax cuts, tax increases of $60 billion, a defense decrease of $25 billion, and nondefense spending cuts of $60 billion, then we will face stagnation, stagflation, and reduced expectations for the rest of this century.

This was a call to arms, the likes of which I have never seen, with at least five Republicans challenging a Republican administration.

EXPECTATIONS OF MONEY MANAGERS IS IMPORTANT

Now, my question to you is this, do these people speak for Wall Street, speak for business, speak for the Fortune 500, and if not—or if they do, I should say, then is it no longer important what the expectations of Wall Street and the money market managers are?

Secretary **Regan**. Well, Senator, I have to say that the expectations of money managers are very important, because the interest rates are set in a very competitive market. These people are in that market, and it is their hopes and fears combined that make for the level of interest rates.

As I suggested in earlier remarks, there are worries about monetary policy, and they are also worried about fiscal policy at this particular point.

From the point of view of what happened from 1981 on, even those gentlemen and their economists missed as we did, the fact that the world was going into a recession, which officially started in July 1981, and has continued until the last month or so.

Senator JOHNSTON. But do these people speak for Wall Street, now?

Secretary REGAN. No one speaks for Wall Street, Senator, being very honest about it.

Senator JOHNSTON. Not even this collective group?

Secretary REGAN. Only in the marketplace. There are many of us who may think we know what Wall Street stands for, but you have got to remember that there is a Wall Street, a LaSalle Street, a Montgomery Street, as well as Tokyo, Hong Kong, Paris, and London. All of these international markets are engaged in the same thing. So anyone who purports to speak for Wall Street has a lot—is taking a lot on his shoulders.

Senator JOHNSTON. Well, let me say I do not know who they speak for, but there sure are a lot of them. Their voices are very loud, and are coming through loud and clear to me.

LET REAGAN BE REAGAN

There is a saying going around now that we should—or that the Republicans should "let Reagan be Reagan." Somehow they figure that they know where the true Ronald Reagan is. It seems to me that the trouble is we let Reagan be Reagan when it was wrong to be Reagan, back when we had these tremendous defense increases, and huge tax cuts, and tight money, and all those things, that that really was the real Ronald Reagan. It was wrong to be Ronald Reagan then, I think.

Now, I think the real Ronald Reagan would tell us, I believe, that the $189 billion deficit for 1984 is certainly wrong, that an abandonment of a balanced budget permanently, or at least as far as the eye can see between here and 1988, that budget deficits of over $100 billion are wrong. I think the real Ronald Reagan would tell us one of these jumped up jobs programs of $4.3 billion will be wasteful and come on too late and will not help very much, and will tend to be permanent, I think he would say that is wrong. I think the real Ronald Reagan would not be for that.

So why do we not let Reagan be Reagan now, at least insofar as getting that deficit down to controllable amounts, down at least down to where Peterson, Connolly, and Simon, and that crowd say it ought to be. Why should we not let Reagan be Reagan now?

Secretary REGAN. Well, first of all, this is the President's budget. He signed his name to it. I would doubt if he would disseminate——

Senator JOHNSTON. Does he really want that jobs program? I mean, does the real Ronald Reagan, deep down, want that?

Secretary REGAN. What has happened in the jobs program is that the President is merely joining with your party in bringing forward things that are already in this budget, that were scheduled for 1984 and 1985, and bringing them forward, and seeing if they cannot be speeded up into 1983.

THERE ARE THINGS WORSE THAN DEFICITS

Senator **Johnston**. Let me ask you this. Which was the real Ronald Reagan, the one who submitted a $189 billion deficit, and $100 billion deficits for as far as the eye can see, and the one I heard out on the north front of the Capitol, who had the pep rally for the balanced budget amendment? I mean, has that been ended now? Do we no longer believe that?

Secretary **Regan**. You have to remember that in the meantime, due to this severe recession, and antiinflation policies that have been adopted, receipts have fallen dramatically. Receipts in 1983 are going to be about equal to what they were in 1981. As a result of this disinflation there is no year-over-year increase in receipts such as we have come to expect. And along with the high unemployment this is partially the reason for the $189 billion deficit.

I think the real Ronald Reagan would agree with you, he would like to see that deficit cut in half, or more. But he also recognizes that would be—perhaps doing that would be worse than having the deficits. There are things worse than deficits, which is higher rates of interest, higher monetary growth, higher unemployment, and things of that nature. We might kill the recovery if we really started increasing taxes at the rate that was suggested by these people.

Senator **Johnston**. Yes; but you see, the third year of tax cut is not really a tax increase, at least not in my mind, and we have had some suggestions for that from this side of the aisle.

My time is up.

Thank you very much, Mr. Secretary.

Chairman **Domenici**. Do you think we will ever know the answer to your question?

Senator **Johnston**. I know what the real Ronald Reagan wants. I will tell you about it later, Peter.

Chairman **Domenici**. All right.

Senator Grassley.

MAKE CONGRESS RESPONSIBLE

Senator **Grassley**. Thank you, Mr. Chairman.

I want to ask you a question on ballooning M2 money category. But, before I do that, I hope it is not presumptuous of me to give the administration some advice for you, on answering the specific Senator, or Congressman on this point of the permanent tax cut.

I would like to have the administration come at it from this point, that it is not a permanent tax cut. What we are doing is taking away the automatic tax increases, and when I voted for indexing, I did not vote because I wanted to lower taxes. I voted to make the Congress more responsible in the sense that if we are going to have more money to spend, that is beyond the real growth of the economy, now I am not talking about where there is real growth, that money ought to come in automatically as we expand our economies, but where there is inflation of 10 percent, and the tax increase is coming in at 16 percent, then that is tax increase we have voted, and it is for those people who do not like what they refer to as the permanent tax cut, then I think it is like saying that they do not have sense enough to vote for a tax increase.

I think we ought to be putting the Congress in a position where it is responsible if they want more money to spend they ought to vote the tax increase. And it is the mechanics of it that is more important than whether or not it is more or less taxes. That is the way I think the administration ought to pursue that.

Secretary **Regan**. Good point, Senator.

Thank you.

GROWTH OF M_2 MONEY IS A CONCERN

Senator **Grassley**. Now, I hope the Administration is becoming concerned about the 30 percent growth of M_2 money. I just think it is bad, I guess I want to know how you look at it, and I know I should be asking that question of Paul Volcker, as well, but I know that there is close contact between Paul Volcker and the administration, and there ought to be, and that there ought to be a coordination of effort to a fair extent without compromising the indendence of the Fed.

Beyond that I think this is—maybe it had not reached the point yet where it ought to send up a danger signal, but it is almost there, and I think that as people lose confidence in it, we are going to have an increase in interest rates, just because people are taking protection, and that scares me, because I think the recovery of this economy is directly related to the reduction of interest rates, or maintaining the reduction that we already had.

Secretary **Regan**. Senator, I understand that Mr. Volcker is testifying this morning, and I have been told—I have not read his testimony, that he is calling for growth in M_2 of between 7 and 10 percent this year.

I would say based upon that, that the Fed considers that that 30 percent increase in January, of M_2, is an aberration brought on by the change in these money market deposit accounts, which started on December 14 and which, as you know, gained well over $100 billion in the month of January alone.

Accordingly, that type of behavior of M_2 should not reoccur month, over month, over month. If it would occur, it is recognized by all of us that it would be absolutely too much stimulus. I would suggest that what we would have to do is to watch the aggregates, particularly M_1 and M_2 over the next several months, and I, believe, at least it is our conviction at this point, that most of this noise will be eliminated from those figures. They will quiet down, and then we will see the true growth of money.

If indeed the Fed can hit 7 to 10 percent on M_2, fourth over fourth quarter, that would be adequate, I believe, for the type of recovery that we forecast.

CUTTING OFF MONEY SUPPLY HAS TO BE GRADUAL

Senator **Grassley**. Well, I think there has to be some sort of a quieting message come out of the administration, of the Fed, pretty soon. Because if you look at recent comparisons between increase of explosion of money supply, and then increase in interest rates since June 1978, you will see that in three times they paralleled each other—when I say paralleled, I mean they followed each other, by about 3 months, and so we could be seen on increase in interest rates in April, as a result of this, if there is not something done quickly to quiet people, that is my feeling, and I do not see that 1983 is any different than 1978, 1979, and 1980, when it happened.

Secretary **Regan**. I think the Fed is not deliberately on that course. I have no reason to believe that the Fed has deliberately tried to pump up the monetary aggregates at the rate they have been going in January and February. As I say, they feel that a lot of this has been brought about by the deregulation of some of the financial instruments. Hopefully that is correct, and if that is correct, I can assure you that the situation will gradually be eased as the months go on.

On the other hand, I really would not want to urge them to push the brakes, you know, and cut off the money supply right now, because that would indeed abort the recovery. It has to be gradual.

Senator **Grassley**. What sort of feeling did you express to Mr. Volcker?

Secretary **Regan**. Just what I have said to you.

Senator **Grassley**. Thank you.

Chairman **Domenici**. Senator Metzenbaum?

NO POSITION ON ARTIFICIAL BAD DEBT RESERVE

Senator **Metzenbaum**. Mr. Secretary, last year's Budget Committee report indicated, in their tax expenditure booklet, that is, that the bank's artificial bad-debt reserve is a major reason for low effective tax rates paid by banks.

As you know, we have enacted legislation to bring that artificial reserve down, now it is at six-tenths of 1 percent, to phase it out. But last year Treasury supported the effort to keep the bank bad-debt reserve deduction at 1 percent of outstanding loans.

Are you going to continue that position, in view of your testimony here today, that banks are only paying an average of 10 percent?

Secretary **Regan**. Well, we were sensitive then to the fact that the—we were in a recession. Bad debts were piling up——.

Senator **Metzenbaum**. Just yes or no. Are you going to support that position?

Secretary **Regan**. We have not come down on a position yet.

Senator **Metzenbaum**. Pardon?

Secretary **Regan**. I do not know. We have not made up our minds on a position. But I would like to explain a little bit more about why——

Senator **Metzenbaum**. No, let me just go on, because I only have 5 minutes.

I think the question is, if you do not know your position at this moment, then I am really not interested. But it seems to me that if you want banks to pay their fair share of taxes, that you ought not to try to convince the Congress to change the law, because the Congress did change the law to phase out that artificial bad debt reserve.

You are, as I understand it, as the Secretary of the Treasury, a member of the Cabinet, you are the President's adviser, and tell him what his tax programs are and are not, is that a fair statement?

Secretary **Regan**. I am one of the chief advisers in that area, yes.

EXPLAIN TAX LEGISLATION TO THE PRESIDENT

Senator **Metzenbaum**. Let me ask you, Mr. Secretary, the President, on February 14, made this public statement, "I know this thing about supposedly our tax program is for the rich. I have never been able to figure that out."

Now, have you explained to him that his tax bill legislation, which we enacted, would provide that an American earning $200,000 get a $58,000 tax cut through 1984, but taxpayers earning $10,000 and $15,000 will average a $483 tax increase, that the Federal estate tax has been all but eliminated for the rich, under his tax bill, so that only three-tenths of 1 percent of all estates will be paying taxes, that the marginal tax rate drop from a maximum of 70 to 50 percent, a cut of 30 percent for the rich; that the capital gains tax, which Democrats had cut from 48 to 28 percent, that under his tax bill they cut it another 30 percent, to 20 from 28 percent; that 16 Senators, some of whom are sitting over there, wrote a letter to the President of the United States, and said, "Mr. President, we did not understand when we passed your tax bill that by 1985, 50 percent of the corporations of this country will not be paying any taxes."

If you explained to him that he tripled the tax on telephone bills for average people, doubled the tax on cigarettes for average people, that you, as his adviser, have publicly indicated there may be a tax on unemployment compensation, that you have been talking about a consumption tax, that you have been talking about eliminating the health—you have already eliminated the health benefit deductions for middle-income wage earners, and cut back on casualty deductions, and that the proposal that you are talking on a standby basis is a 12-cent-a-gallon tax increase, would you explain to him so that he might understand why the people of this country think that his tax programs help the rich and hurt the poor, because apparently he does not understand.

Secretary **Regan**. Could I explain that to you, Senator, first, because I disagree with what you have said.

Senator **Metzenbaum**. Well, you are welcome to disagree, but I stated only facts.

Secretary **Regan**. Well, some of your facts are incorrect.

Senator **Metzenbaum**. Which one?

Secretary **Regan**. The unemployment tax. That was established by the Congress in 1978.

Senator **Metzenbaum**. If you are talking now about tax——

Secretary **Regan**. Wait a minute, Senator. Let me answer the rest of your points that you have made, since you have made this scurrilous attack on the President.

Senator **Metzenbaum**. I have not made any scurrilous attack. I have asked you to explain what the tax law is about. He does not seem to understand.

TAX CUT HAS BEEN VERY FAIR

Secretary REGAN. The President knows darn well what the tax law is about. He is very familiar with it.

Now, the facts are that the tax cut, the distribution of the tax cut, was exactly in proportion to the taxes that are paid by various people, in adjusted gross income classes. There has been a very fair tax cut, right across the board.

The fact that, if you pay more taxes, you get a bigger tax cut, should not surprise anyone. I mean, even a second grader could understand that.

Senator METZENBAUM. Well, the biggest tax cut was for the rich, and the poor and middle-income earners did not get——

Secretary REGAN. The rich pay more taxes?

Senator METZENBAUM. Of course, they pay more taxes than they should.

Secretary REGAN. Then an across-the-board tax cut, that is very even for everybody, would naturally give them the same proportional reduction but for them it would be a larger amount.

Senator METZENBAUM. But the 70 to 50 percent for the maximum, 28 to 20 percent, the investment tax credits that you gave to the corporations, the accelerated depreciation, 16 Senators wrote the President a letter—I never did see the answer—saying that we did not know that 50 percent of the corporations would be paying no taxes by 1985. Does he not understand that?

Secretary REGAN. As I recall, the 70 to 50 percent was the suggestion of a Democrat.

Senator METZENBAUM. I do not care if it is a Democrat or a Republican, it was on the President's bill.

Secretary REGAN. No, it was not. It was added to the President's bill in 1981.

Senator METZENBAUM. And you accepted it.

Secretary REGAN. Yes, after you suggested it.

Senator METZENBAUM. I did not suggest it. Do not say I did.

Secretary REGAN. Your party did. We were in a type of compromise at that time. As I recall, we were trying to fashion a compromise bill.

Senator METZENBAUM. More for the rich, take care of some of those boll weevil Democrats.

LET ESTATES BE PASSED TO CHILDREN

Secretary REGAN. Now, let us talk about some of these other things. You are talking about estate and gift taxes. At the current moment the estate tax exemption is about $285,000. It is to rise to $600,000 in 1986. Take a look at all the small businesses in the United States, there are 16,500,000 individual proprietorships, or what have you, people trying to build up estates. These are not wealthy people. They are trying to build up a little bit to leave to their people.

Senator METZENBAUM. It is not $600,000. It is $1.2 million for a husband and wife, if you have the right tax consultants.

Secretary REGAN. Well, that is out in 1986. Do you agree with me that it is not at that point right now?

Senator **Metzenbaum**. No, it is going up. Why do we not put that on a standby basis?

Secretary **Regan**. Are you against farmers being able to leave their farmlands?

Senator **Metzenbaum**. No, but it is not only the farmers. We had amendments on that score on the floor of the Senate, and we were willing to take care of those farmers. That is not the issue.

Secretary **Regan**. The issue is whether or not an American can make and hold wealth, and pass it on to his children.

Senator **Metzenbaum**. Right.

Secretary **Regan**. I say they should be able to. You are saying take it away from them.

Senator **Metzenbaum**. I am saying there ought to be fair taxes, they ought to be equitable. I think there ought to be a balance.

Secretary **Regan**. And it will never get above $600,000. It is not for the very wealthy.

Senator **Metzenbaum**. It is $1.2 million, it is not $600,000 for a couple, $1.2 million. All you do is establish a trust, and you work it out. Any consultant can tell you that, and you know that.

Chairman **Domenici**. The Senator's time is up. If you care to answer, you can.

Secretary **Regan**. No, I think we have had enough on that.

Chairman **Domenici**. Senator Metzenbaum ought to know about tax trusts and all those things.

Senator **Metzenbaum**. I certainly do, Mr. Chairman, and I think they ought to be fair and equitable, and I think I ought to pay my fair share, and you do too, and Mr. Regan, as well.

Secretary **Regan**. I do.

Chairman **Domenici**. Senator Quayle?

Senator **Quayle**. Thank you, Mr. Chairman.

MAKE ITEMS AVAILABLE SOONER RATHER THAN LATER

Mr. Secretary, in your testimony, in response to Senator Johnston, you referred to a jobs program that you are working on with the Congress.

I wonder if you might outline that jobs program for us?

Secretary **Regan**. Unfortunately, Senator, I cannot. The negotiations are still going on, and it has not been made final, but in general it is an attempt to see what can be done to make some of the items that are currently in our budget available sooner rather than later.

An example, we have in the budget certain projects for GSA, such as an office building or a warehouse, something of that nature, that will be funded in 1984 and 1985.

Perhaps that can be brought forward and started in 1983. We know that there are a lot of things in the veterans area, such as renovating veterans hospitals, or building additional hospitals. Perhaps those can be started in 1983, in order to make jobs available now, rather than in those outyears.

Senator **Quayle**. Are you basically talking about construction jobs, and public works, in trying to bring some of the moneys forward? For example, the GSA and the veterans? Is that basically what this jobs bill is going to be?

Secretary **Regan**. In general, that is what it is. With some additions targeted for food and shelter, for the truly needy.

Senator **Quayle**. Will the money for food and shelter also be brought forward out of 1985, or will that be new money?

Secretary **Regan**. It is my understanding there is about $700 million of new money that will be—that would be asked for in this bill.

Senator **Quayle**. OK.

But there will not be any new money for a jobs bill, as such. It will all basically be money that is in the pipeline, accelerated and brought forward in this year, rather than waiting for next year. Is that correct?

Secretary **Regan**. Subject to the numbers that are being worked on now, in general, yes.

Senator **Quayle**. Mr. Secretary, do you think if we talk about a jobs program that we should be concerned about the amount of money that we have to expend per job?

For example, if you look at the jobs that I think you are talking about, you are looking at perhaps a cost of as high as $60,000 to $70,000 per man-year. On the other hand, public service employment and some other jobs proposals that you could provide jobs at as low as $15,000 per man-year.

If we are really concerned about a lot of jobs, and an acceleration of public spending, should not a significant factor be the amount of money that it is going to cost the Federal Government, that would translate into jobs?

Secretary **Regan**. Well, what we are trying to do, Senator, is to try to draw a line between make-work jobs, and actual jobs that will result in benefits to the country. If you get into just throwing money at the problem, putting people to work, you are getting into make-work types of things.

PROPOSAL HAS SECOND PHASE

Senator **Quayle**. We are not talking about make-work jobs. I think even the President and even you have probably been quoted as saying that not all public service jobs are make-work jobs. We are not talking about leaf-raking jobs. We are talking about jobs that may have a public purpose, and for which there is certainly a public need.

But I think that the road that you are embarking on will in the long run, provide for the very high-paid, high-skilled, high-cost jobs. I am not going to argue with that. I think that perhaps that should be done. However, I think that there is another concern; that has to do with some of the lower cost jobs that would translate into many more jobs, that will get at the lower skilled, the minorities, the women, the other people that are usually the last hired, first fired. If what you have outlined to me here, is the course that we are embarking on, so therefore, I would ask is there going to be a second phase to the job proposal that the administration would be willing to consider beyond this one?

Secretary **Regan**. Well, in our budget proposals we have proposed the training of at least a million people a year. This is training of youth, where the highest unemployment percentagewise exists now, and also retraining workers who might be permanently out of jobs. So we do have quite a bit in the budget currently for retraining.

We are also asking for a reduction in the minimum wage for summer jobs for youth. We also are proposing a voucher system, whereby unemployed persons could approach new employers and offer them vouchers equivalent in value to half of the usual unemployment compensation, which would be used as an offset against the wages, thus providing an incentive to put these people back to work. So there is a second phase to our proposal.

Senator QUAYLE. OK. That is my question.

There is going to be a second phase, and a second part to this job proposal——

Secretary REGAN. Actually it is phase 1 that has now been overtaken by a new phase 1, called the jobs program.

Senator QUAYLE. This is sort of an emergency acceleration of the public works programs that are already on the books. You are talking about phase 2, which gets into training and retraining for the dislocated worker.

I know that you have $243 million for fiscal year 1984. We put in $50 million, and the continuing resolution was knocked down to $25 million in the conference committee. It is therefore quadrupling, or even eight times more than the Congress has done. So there will be a second phase, and I thank you for that clarification.

Chairman DOMENICI. Senator Exon?

PIK PROGRAM HAS DIFFICULTIES

Senator EXON. Thank you, Mr. Chairman.

Mr. Secretary, as Secretary of the Treasury, I would like to get your opinion on what we are going to do with the farmers on the difficulties that I think you are aware of, with regard to the PIK program. March 11 has been the end of the sign up period, and many farmers are confused today because it has been interpreted that the income tax laws as they currently stand would require them to pay possibly 2 years of income if they had sold the products this year, and now take some PIK programs.

We have to have a fast track on this, and I wonder if you agree that we should change the law first and; No. 2, how much cooperation can we expect from you and the administration to put this on a fast track so that we can get this corrected sometime prior to March 11?

Secretary REGAN. Senator, we are very much aware of this and at Treasury we are trying to be as cooperative as we possibly can.

We have not issued any such ruling. We will not issue such a ruling but if asked for a ruling you're entirely correct, this is probably the way we would have to rule. As a farmer receives commodities from the Government, he would have received income on which taxes would be due.

We would rather see the law changed to say that income is declared when the commodity is sold and taxes would be due on it then. So we are working on it. I have talked to the members of the Ways and Means Committee of the House yesterday on this. We have already spoken with the Senate Finance Committee. We intend to push this and lend every support that we can to getting a bill through the Congress by March 11, sooner, actually if at all possible.

I might add at least for the record, that if such a bill comes through, I would hope that all sides would restrain themselves from adding anything to the bill so that it could go through quickly without controversy. I think that most would agree that this is a necessity for the farmers of America.

Senator EXON. I am encouraged with your statement and we are going to need the help of the administration if we can get something through, and there are several ways that we could do it that I might go into with you at a more opportune time.

BANKING SYSTEM IN GOOD CONDITION

Let me get into another important subject. As Secretary of the Treasury, I would like to have you give us some thoughts today about how serious is the internal banking situation in America, with the Penn Square situation and then a few days ago the failure of the bank at Knoxville, Tenn.; are we going to—we have seen several bank failures.

How serious is this?

I think that question is being asked by an increasing number of people today, and I would like to have the opinion of the Secretary of the Treasury on this.

Secretary REGAN. Senator, in general, I think the banking system of the United States is in good condition. It does have many problems, problems with nonperforming loans, of poor loans, substandard loans, some of them domestic, some of them international.

We are in a very tight situation as far as the international situation is concerned, but let me speak to the domestic side first.

With the recession that we have had and the like, there have been many businesses that have been strung out, small as well as large. The net result is that the banks have had to work with these clients helping them along. The number of bad loans that have been created, thank goodness, in most banks is limited. There have been some banks that have gone overboard.

We had one in Oklahoma, and now we have had one in Tennessee where the lending policies of the individual banks have been such as to create these difficulties.

I think that these are the exceptions rather than the general rule of what is going on in the banking system today.

As far as the international situation is concerned, in my opening——

Senator EXON. Let me—I asked you internally.

Let me phrase the question on this next——

Secretary REGAN. Go ahead.

ADDITIONAL MONEY NECESSARY FOR IMF

Senator EXON. I think that most people recognize that we have some difficulties around the world. Probably if there have been bad loans made internally by banks, it is miniscule by comparison with the bad loans that have been made by some very large banks with regard to their loans overseas.

Now, there is a growing concern in this country today and I feel that and hear about it in Nebraska as much as I hear about it in Washington, D.C. We want to be helpful, because we recognize it is international trade and the international banking system is very important to all of us, but I would hope that you and the administration, when you send over recommendations for the International Monetary Fund and other systems, would realize and recognize that something like this is not likely to get through Congress if we are simply going to eliminate the risk and the potential loss of some of the large banks that are presently exposed to you.

Let me put it this way.

If a farmer in Nebraska had made a loan to the Government of Mexico to buy some wheat, for example, and the Government of Mexico could not pay for it, I do not think we would probably get much sympathy for the farmer coming to the U.S. Government saying you have to cover my loss.

I just want to emphasize the fact that in talking to my colleagues here, there is grave concern about what we are going to do in this whole international marketplace with regard to making sure that we just do not put up an awful lot of money to rescue some bad loans that have been made by especially big bankers.

Secretary REGAN. Well, we have no intention of asking the Congress to do that.

What we are saying is that additions to the resources of the International Monetary Fund, as described in my prepared remarks are necessary to assure an international trading system. If we have no international monetary system we have no international trading system. Far from rescuing or bailing the banks out, none of this additional IMF money will go to the banks themselves. In fact, as in the cases of Mexico, Argentina, Brazil, the banks have to put in more money in order to keep those economies going.

What we are basing our judgment on is the fact that exports are a necessity for the United States. As you know, 40 percent of our agricultural acreage is devoted to production for foreign trade.

WE HELP OURSELVES BY HELPING MEXICO

I was a little bit amused that you are talking about the farmer from Nebraska selling to Mexico. Actually, what has happened is that the CCC has guaranteed quite a few billion dollars in loans to Mexico and were Mexico to default on all of its debts, the U.S. Government would be the one left holding the bag.

We think that by keeping Mexico going we are doing ourselves a service. U.S. exports to Mexico totalled almost $18 billion in 1981. But Mexican imports dropped off significantly last year, before there was an IMF program with Mexico. Consequently, U.S. exports to Mexico last year were down about $6 billion.

Now, that is hurting us at home. It helps us for an international organization to work with Mexico to help restore the economy and not default on those debts.

Accordingly, we really help the United States when we agree to these increases in the IMF.

The final thing, as I have already testified to the Senate Banking Committee, I think that it is proper for the regulators—the Federal

Reserve, the Comptroller and the FDIC—to take a very close look at what should be done in the regulatory field in order to make certain that banks are not making imprudent or too many loans to some of these foreign nations.

Senator EXON. Well, Mr. Chairman, my time is up.

Let me just respond by saying——

Senator CHILES. You mean too many more?

Secretary REGAN. Too many more.

Senator CHILES. They already made too many.

Senator EXON. Mr. Secretary, let me say this.

It is not amusing to me when I use a comparison that I just used.

Secretary REGAN. I did not mean to denigrate you, Senator.

I was just thinking, the joke is not—that the farmer has been smart, he has had the Federal Government do it. The farmer has been the smart one in this. He has not made direct sales.

Senator EXON. Well, and you would know full well under our trading system it is most difficult for him to do that.

I just want to emphasize and underline once again, that anything that comes down to the administration that is perceived as a bailout for the banks, at the cost of the taxpayer, it is not likely to get very far in the Congress, in my opinion.

Chairman DOMENICI. Thank you, Senator Exon.

Senator Hatch?

GROWTH OF MONEY SUPPLY HAS NOT BEEN STABLE

Senator HATCH. Mr. Secretary, happy to have you here.

I am pleased to note that throughout your testimony, you have recognized that both the gradual and steady growth of the money supply is the key to economic recovery and may be the key to avoiding any rekindling of inflation. Yet, there are some ways in which I have to share the chairman's concern, and also the concern of Senator Grassley, that since the Fed's fall 1979 policy of tracking M-1, or the growth rate of the money supply, that rate has been anything but stable. Perhaps more ominously, the M-1 measure of the money supply grew in 1982 by 8.7 percent.

Now, contrast that rate with the 1977 rate of 8.1 percent and a 1978 rate of 8.3 percent, which produced the inflationary spiral beginning in 1979 and 1980. So, I am concerned.

Yes; I believe that we are going to have a pretty good economic year this year. I think we will come out of it pretty well, especially in the latter half of this year. I think that the tax rate reduction will also spur that on.

But I am concerned about that type of growth in the money supply and the commitment of this administration in keeping it stable.

Let me ask you a question.

Your recognition that the President's tax cut and indexing programs are not the cause of economic decline and budget deficits—and are, in fact, necessary to reduce taxation as a percentage of both GNP and family income to more traditional levels below their peaks in the Carter years—I think is commendable.

You also note that the administration's economic recovery and deficit reduction proposals depend on controlling the increase of spending under entitlement programs, the so-called uncontrollables in the Federal budget.

Now, can you give us an outline of how the administration plans to review these programs to limit their ballooning growth which has been occurring over the years, and yet insure that the truly needy are, indeed, cared for?

I might ask one other aspect of that and that is, can you give us your analysis of how you plan to contain off budget spending as well?

GROWTH OF MEDICARE SHOULD BE HELD DOWN

Secretary **REGAN**. I think the best illustration is in the field of health care.

As we all know, rising health care costs is one of the major causes for the increase in the CPI. The medical component of the CPI is rising at about 10 percent as compared to the overall rate of 3.9; something has to be done.

The Federal Government is partially responsible here as a third party payer, both in the field of medicare and medicaid. Now, medicaid is for the truly needy, and that we must keep in place. But medicare is where we have to slow the rate of growth down.

I don't think we will ever be in a position to actually cut medicare, but we should try to hold down the rate of growth of the program costs.

One of the things in the health care field we are going to suggest is in my area of taxes. We are proposing that the amount that an employer can give tax free to pay for an employee's health insurance premiums be limited to $175 a month for a family plan. Currently the tax-free amount is not capped at all. It seems to us that a premium of $2,100 a year is a very generous health insurance plan. We think this limit on the tax-free contribution will tend to reduce insurance coverage that leads to wasteful use of health care services and bids up costs for private patients as well as those in public programs. Thus this proposal would help slow the growth of medicare costs, a major uncontrollable program.

Now, from the point of view of off budget spending, I agree with the Senator, I think this is one of the things that we as an administration, and I would hope we would have the agreement of the Congress in this, that as much as possible such spending be kept on budget, where the Congress can review it, where the Congress can see what is happening, and where we can make informed judgments

We are really slowing the growth rate of the off-budget items over the next 3 to 4 years.

PEOPLE WILL PAY MORE TAXES IN 1983

Senator **HATCH**. I appreciate that.

I just have one other comment I would like to make. That is, even with the passage of the Economic Recovery Tax Act of 1981, personal income tax rates will fall just short of compensating for the effects of inflation forcing taxpayers into higher income tax brackets.

For example, the average combined Federal and social security taxes and State income taxes paid by a family of four with an income of $15,000 filing a joint return in Utah amounted to an average combined tax rate of 17.4 percent in 1980. If we assume increases in salary to compensate for inflation, this family's average tax rate in 1984 will have risen, even with the 1981 tax reductions, from 17.4 percent to 19.3 percent, for a dollar increase of $287.

In other words, even with the Economic Recovery Act of 1981, people probably are going to be paying more taxes in 1983. I think that is what the people fail to understand. And, I have never seen a tax increase that has resulted in deficit reductions or, should I say, resulted in national debt reductions.

And yet these people keep talking about taking away the tax rate reduction for 1983, the July reduction. And if they do that, it just means an automatic increase in taxes, and even then the American people will not have been able to catch up unless we keep those tax rate reductions of 25 percent permanent thereafter.

And that, hopefully, will spur the economy.

So, I very much appreciated your stand in trying to keep those in effect.

Secretary REGAN. Thank you, Senator.

Chairman DOMENICI. Thank you, Senator Hatch.

I understand the Secretary would like very much to leave by noon. He has a White House appointment, is that correct, Mr. Secretary?

Secretary REGAN. That is correct.

I have a meeting with various Senators and Congressmen.

Chairman DOMENICI. We will try our best.

Mr. Secretary, let me ask you just a couple of questions.

PRIME RATE IS RELEVANT TO ACTUAL CHARGE

With reference to our domestic banks, it appears that when we read about prime interest rates, it makes us feel like we are really making some headway.

But I assume you know, that out there in the hinterland, the prime rate is very relevant in terms of what the banks are actually charging their typical consumers, be they farmers or somebody who wants to buy a car, or finance something through them.

Prime is—they have the real prime anywhere from 3 to 5 percent, from what I can tell out in the country.

Is this what you are finding?

Secretary REGAN. Well, it depends upon the credit worthiness of the borrower and quite a few other things. But, no doubt, consumer loans are in the 15 to 17 percent area for the most part right now.

Chairman DOMENICI. Do you not think, Mr. Secretary, that we have to ask the average American to have some confidence and begin to act like an ordinary consumer, which I assume has got to happen. I do not think it is the 10 or 11 million unemployed by themselves that are dragging this economy down. I think it is 25 million around them that are acting out of fear. As our economic facts get better, I assume they will act more like normal consumers and not so much out of fear.

Do not we have to expect the same out of the banks?

Secretary REGAN. Well, there is no doubt that as interest rates come down, this engenders more spending.

I can point to the automobile industry as a case in point, when sales were not going well, they had the courage to reduce the rates for installment buying of an automobile to the 11-percent area, 11.9 percent, and sales immediately increased. They are continuing, not too robust, but at least they are continuing to do reasonably well.

Were we to get to a point where those rates were single digit, I think you would see automobile sales increase dramatically.

The same thing with mortgages.

Chairman DOMENICI. Well, I am not one to give advice at a public hearing, but it seems to me that there is room here for some jawboning in terms of the consumer rates on the part of banks across this country, and I hope you will consider it.

Let me ask you a question, Mr. Secretary.

You read Congressman Dan Rostenkowski's proposal with reference to taxes, which did not affect the last installment of the tax cut, then froze any additional tax cuts. I assume you do not support that proposal, is that correct?

Secretary REGAN. That is correct.

THREE-YEAR DEFERRAL VERSUS 5-PERCENT SURTAX

Chairman DOMENICI. Let me ask you, what is the real difference between—just specifically, a 3-year deferral of an index program—and I use the word "deferral" based upon your present assumption of inflation rates, and a 5-percent surtax which the President recommended?

Secretary REGAN. You mean in dollars, Senator?

Chairman DOMENICI. Well, what is the difference economically? Why will one be good and one be bad?

Secretary REGAN. Oh, let us face it, if you do away with indexing——

Chairman DOMENICI. I did not say that.

I said, 3-year deferral of indexation versus a 3-year, 5-percent emergency surtax to bridge the deficit gap, from the standpoint of our economy, what is the difference?

Secretary REGAN. All right, then.

I think that the latter is better for the economy than the former.

If you defer indexing, what you build in permanently to the tax system is whatever the inflation rate is, and whatever the real rate of growth is in the economy.

In other words, the nominal rate is built in. You would start indexing at a higher level than you would in 1985. So you have a permanent tax increase built into the system. Whereas if you have a temporary surcharge, you have the average, of all taxpayers, having their rates held down, at the same time they have a temporary surcharge that is then eliminated and you do not have that permanent increase built into the system.

Chairman DOMENICI. So if there is a real economic downside, and I did not get rid of the philosophy of indexing because I just deferred it, then it would be that you also ought to have adjustment 3 years later of some type to get the base down to where it would have been before, is that correct?

Secretary **Regan**. That is correct.

Chairman **Domenici**. Is it not true that from the standpoint of the philosophy and theory of indexation, that almost everybody that has studied it would say, looking at the old Tax Code with all of its warts and deductions and the like, that it is far more important that you have it when you have a very high inflation than when you have low inflation?

Secretary **Regan**. Oh, yes, verv definitely.

Chairman **Domenici**. We have very low inflation predicted for the next 5 years, do we not?

Secretary **Regan**. No.

It's average——

Chairman **Domenici**. Compared to when we put indexation into the law.

Secretary **Regan**. Oh, yes. Yes.

Chairman **Domenici**. Almost—it is almost cut in two. It is 4½.

Secretary **Regan**. 8 or 9 percent down to 4½ percent. Yes.

CONSUMPTION TAX HAS ADVERSE EFFECT ON THE ECONOMY

Chairman **Domenici**. With reference to consumption taxes, a lot has been said here about the so-called Peterson group's proposals. They are all kind of wonderful when you look at them in the abstract. They have $25 billion in defense cuts, we now have formally asked them where, how? They have $60 billion in new taxes. As I understand it, that is all consumption tax that they recommend.

Mr. Secretary, do you recommend that if we are considering taxation in the outyears, a consumption-type tax over the surcharge that the President has recommended?

Secretary **Regan**. No, we do not.

Chairman **Domenici**. Is that because of economics or because of the pragmatics of it?

Secretary **Regan**. Economics.

Chairman **Domenici**. You think that has more adverse effect on the economy than a temporary surtax?

Secretary **Regan**. Yes, we do.

Chairman **Domenici**. Why?

Secretary **Regan**. For the simple reason that you take away from the savings pool of everybody, built in a tax that adds to the CPI, then engenders more COLA's or spending and the like, I think that it is the wrong way to attack the problem.

Chairman **Domenici**. One last question.

HOUSING A MAJOR FACTOR IN COMING OUT OF RECESSION

It appears to me that housing has led us out of every other recession. Is there any change of thinking at this point?

Will housing lead us out of this recession?

Secretary **Regan**. Housing will be one of the three or four major factors in leading us out of this recession.

Chairman **Domenici**. Mr. Secretary, it appears to some who look at the pool of money available for housing that the area of pensions either under ERISA or otherwise, are greatly restricted in terms of their availability for housing. Do you agree with that?

Secretary **Regan**. I agree with that.

Chairman DOMENICI. Is there anything going to be proposed to make that money at least more available without necessarily any targeting and the like?

Secretary REGAN. Yes, we are trying to come up with some suggestions for the Congress in order to change the ERISA laws to allow pension funds to go more into housing.

Chairman DOMENICI. Are you pretty close to arriving at a conclusion on that?

Secretary REGAN. I think that you will see it before spring.

Chairman DOMENICI. Thank you, Mr. Secretary.

Senator Chiles?

Senator CHILES. Mr. Secretary, in your statement you make a great deal of the fact that we need to have this third year of the tax cut and to continue the repeal of indexing for the lower and middle-income taxpayer.

When I look at the total effect of the 25-percent tax cut and see that the total effect is that those within the $20,000 to $40,000 category, those total family earnings, $20,000 to $40,000 gets $710 per year and those with $80,000 or more get $14,200 a year.

It seems to me that it is hard to make too great a case for how we have to protect the lower and middle income wage earner by continuing to give him that tax cut. He is getting such a big part of the pie to start with.

But in addition to that, I see that in 1985, continuing to give the tax cut to those making over $80,000 is going to cost us $22.8 billion. It seems like to me that is $22.8 billion that you could use to reduce the deficit, if you were to forego that third year tax cut for those making $80,000 or more.

It seems like to me—then we could still take care of the lower and middle-income earner that you are so interested in, and who all of us are so interested in taking care of.

Secretary REGAN. Let me try to put some figures up here, Senator. Adjusted gross income classes of less than $50,000 pay, or their liabilities for taxes are, 67 percent of the total, and then the reduction they get is 72 percent. So they get more than their proportionate share.

Now, we think that it is important that that is the group that have been suffering in the recessionary period, in the inflationary period.

They would not get a tax cut at all in that group if we did not have this third year, because they have been required to pay more for social security——

Senator CHILES. Now, I am buying your argument, but I'm going to let them have the third year.

INCENTIVE COULD BE DESTROYED

Secretary REGAN. Then let us get to the remainder of the group. As far as the remainder of the group is concerned, this is where your largest pool of savings comes from. Those that have more, obviously can save more. Those that have more can invest more. These are, also, a lot of small businessmen, individual proprietors, things of that nature. We do know that generally, small businesses create most of the new jobs. Four out of five new jobs come from small business. We know that more than half the employed work force works for enterprises with less than 100 people. What we are saying is that if you say to these people, we are not going to give you a tax cut at this particular moment, you are going to destroy incentive, you are going to cut down on the savings pool at the same time we are trying to finance a huge deficit.

I think that it would be self-defeating to do that.

Senator CHILES. We are giving them that tax cut out of red ink.

Secretary REGAN. We are not really giving them anything. We have not given them anything yet.

I would suggest that if they were asked or if most people were asked, they would say, well, let us cut a little more spending in order to achieve that. Because a dollar spent by a person, an individual, seems to go a lot further in the economy than a dollar spent by the Federal Government.

Senator CHILES. Well, it just seems like to me, that when you are looking at that $14,200 earner, that you are cutting off that person, who is making over $80,000. If you really want to talk about fairness at all, you could try to reduce that deficit so as not to give him a red ink tax cut; that seems to me to make sense.

SEND BUSINESS COMMUNITY A SIGNAL

This is one other question I just wanted you to touch on. A lot of the rationale of the 3-year tax cut was that this is a signal we need to send to the business community so they will be able to plan and also to Wall Street. We were going to send them the signal and it needed to be definite, it needed to be certain, it needed to be multiyear, so they could make their plans accordingly.

Now, in the contingency tax, it seems like to me everything is totally against that. There is no certainty about whether it will come into effect or not. Isn't that going to leave a world of uncertainty out there for the businessman planning, trying to determine what his position is going to be in 1985 or 1986. Wouldn't it be much better to provide that certainty even if we impose the cut or the tax increase sooner, so they will know for their planning purposes, exactly what their situation is going to be?

Secretary REGAN. Well, first of all, if enacted this year, that is, if we go in for the freezes and the cuts and get this budget that we have suggested or something reasonably close to it through, we would then suggest that that tax be enacted this year.

Then a businessman——

Senator CHILES. Is still not certain if it is enacted this year.

Secretary REGAN. No. But he would know that at that point in time either of two things would happen: conditions will be much better, that that is one way to get that deficit down; or, they would know that the tax——

Senator CHILES. He would know that either he would have a tax cut in 1986 or he would not.

He would know either one of those two things, that is what he would know.

Secretary REGAN. He would know what the type of tax increase would be, and he would know the amount of it. He could take that into consideration. Let me also tell you that as someone who has run a large firm, you do not really worry about things out that far, you work in a recession economy such as we are in right now. Most everybody is concentrating right now on 1983 and 1984, and on what is going to happen in those 2 years. Is the company going to survive?

That is what they are worried about right now, and they are worried about whether or not we are going to have big deficits out there that are going to cause inflation to come around so that we again will have another recession. They are asking that we please get those deficits down so that they have more certainty from that.

Senator CHILES. Well, I agree with that.

SHOW DEFICITS COMING DOWN

But I do not think we are giving them much of a signal that we are going to get the deficits down. We are not showing them in 1984 or 1985 that the deficits are coming down.

Secretary REGAN. Well, if the Congress does not enact any tax increases now and says, well, you are going to have big deficits in those outyears, the only thing you can plan for is further inflation.

Senator CHILES. Well, that is exactly why I think you ought to do something now. To show them that you are not going to have that deficit. The argument that you just made is the best argument that I know of as to why you should be getting some revenue now.

You just said the businessman looks at the next 2 years. If you look at your deficits for the next 2 years, you are giving away, or you are going to encourage deficits of $600 billion over the next 3 years, $400 billion over the next 2 years. That is what that businessman is looking at. And I agree with you, it is exactly what he is looking at. Let us show him we are going to get it down now.

Secretary REGAN. How, by raising his taxes or raising his customers' taxes, so they would not be able to buy from him?

Senator CHILES. A combination, but you just said how important that is to show him.

Secretary REGAN. Yes, but what I am saying is, we have to show him a path coming down. But the proper way to do it just coming out of the recession, the first month or so out of a recession, is not to suddenly increase taxes. You will abort the recovery right then and there.

Raising taxes is no way to get an economy out of its recession. I never heard of an economy that did that.

Senator CHILES. Well, I do not know that cutting taxes is anyway of getting out of a deficit of $200 billion a year, and that is what we are doing.

Secretary REGAN. Well, we say to stimulate the economy.

Senator KASTEN [presiding]. Mr. Secretary, I have just one or two quick questions and Senator Exon, I understand, has one or two questions, as well.

I apologize that we are holding you back just a little bit.

DEALING WITH SMALL INSTITUTIONS' PROBLEMS

The small institution problem with this withholding question is still out there. I understand that individual saving institutions would be able to file for a so-called "hardship" exemption for 6 months.

Will banks then have to buy the computer hardware and software in order to comply with the Government regulations within 6 months with no further extensions for the smaller institutions who are no longer able to comply?

Secretary **REGAN**. No.

What we said is if the small institution is having problems and they come forward and explain to us what their problems are, and the like, we will be very sympathetic to extending the period individually for these, but not as a group.

I recently made a speech to the National Credit Union Association, where incidentally I was booed for all of this, but nevertheless, they presented me with some figures. They showed that for a small credit union with less than $500,000 in assets, the total cost of these new programs for the average institution of that size would be $1,400. They showed that a credit union with $10 million in assets would have costs of something in the neighborhood of $59,000.

They said that it would be difficult to put these into effect and when questioned as to why, they said because it would require overtime and people would have to work extra hard and the like. We are telling them that they have 6 months to do this.

Well, it is getting closer, now it is 5 months and we thought they could accomplish a program of that nature within that time. But if there is an institution with a special problem, it should write or contact the IRS, to explain its problem. We will be very sympathetic.

Senator **KASTEN**. As you know, there are varying estimates from different institutions all over the country as to how much it is going to cost them to comply, et cetera.

But now the other side of the question.

SOME INSTITUTIONS CANNOT COMPLY

Let us just say for fun that you have 6 or 12 extra months to comply. You have got two competing financial institutions; one is withholding 10 percent on their interest payments, and the other is not.

The answer that was given to me once before to this question was there was no problem. We are not going to allow the institution that is not withholding to advertise the fact that they are not withholding.

But, I'm not so sure that is an acceptable solution to that problem. What are you going to do when you have one savings institution withholding, and another not withholding in the same market area?

Secretary **REGAN**. We have not crossed that bridge yet because we do not know how many there will be or what the situation will be.

Senator **KASTEN**. The estimate was between 15 and 20 percent of the thrift institutions could not comply. That was 6 months ago.

Secretary **REGAN**. Well, so far 15 to 20 percent have not contacted us and told us that they were having that difficulty. If that is a fact, then we will do something about it because we cannot have somebody that has done his level best and is able to solve the problem at a disadvantage to someone who has different knowledge and cannot comply.

Senator **KASTEN**. I understand that the IRS' credit union is not computerized.

Have you checked with them to see how withholding will affect their credit union?

Will they have to invest in new computers? Will they have to invest in new hardware and software?

What will the effect of that have on your own credit union at the IRS?

Secretary **REGAN**. I have not checked with the IRS' credit union. I will be more than happy to do it.

SUPPORT GROWING FOR REPEAL

Senator **KASTEN**. Mr. Secretary, I hope that we can work together and make some of these changes. It seems to me that the political pressure is growing and we are developing more and more support for repeal of withholding this issue is way beyond the savings institutions. It is no longer a banking or savings and loan issue. It is a savers' issue. It is a people's issue, and when an issue gets to the point of being a people's issue it is something that we have a responsibility to try to deal with.

Secretary **REGAN**. Well, Senator, what we are trying to do at Treasury is try to explain our side of the situation, try to explain more about what the exemptions are for those in the lower income tax bracket, those that do not have much in the way of savings, as well as for the elderly, and we are trying to work with the institutions to see exactly what their problems are.

We know that initially they put up this fight. We are trying to take some of the heat out of it and put more light into it.

Senator **KASTEN**. You talk about the small people. If you earn less than $150 in your account, then you are exempt.

Secretary **REGAN**. That is right.

Senator **KASTEN**. Let us say the first quarter you get $50 in interest. That now becomes an account that you would withhold on, because you would assume that it might get to $200 by the end of the year.

Unfortunately, or fortunately, the fact is that most people do not have the same dollar number in their savings account every single month or every single quarter of the year. You are asking banks to make a judgment on that and I guess the IRS is going to come and police the banks as to whether or not they withheld at the peak or at the valley of a particular account.

That is a whole separate group of problems which once more point out the fact that we do not know what this is going to do. The banks and thrift institutions are caught in a limbo, and are in the process of being put in the position of being an IRS agent, which is not the proper role of a bank.

BANKS ALREADY HAVE NECESSARY HARDWARE

Secretary REGAN. Well, let me point out a few things along that line.

First of all, if a person knows that they will not have more than that particular amount of interest in the course of a year they can gain an exemption and merely tell the bank and the bank is relieved of the responsibility.

Senator KASTEN. They might not know that.

Secretary REGAN. This is what I am saying.

It is up to the bank as well as to us at Treasury to make these facts known and that is what we are trying to do: To get these facts across to people.

Second, as far as the banks being agents, right now the banks have the responsibility for doing several things in the collection area. First of all, they have to withhold on salaries. They know that. They are doing that.

Third, they have to comply with the 1099 program. This is not that much more difficult than the 1099 program which they are already doing.

Senator KASTEN. Well, you told me earlier that you were going to get rid of the 1099's.

Secretary REGAN. I meant to say that the new program replaces the 1099 progam.

Senator KASTEN. So you cannot say that they now have the 1099, but are not using them. But I do not want to take anymore of Senator Exon's——

Secretary REGAN. The software is not that much different from the 1099 program.

Senator KASTEN. Well, then, match them up.

Secretary REGAN. No, I'm talking about at the bank level. They already have the hardware or some method of producing the 1099 and it is that same hardware they will use with the modification of the software in order to produce the new form. So there is part of the extra cost. Plus, of course, the banks have other responsibilities, you know, to the Federal Government such as the currency problem.

They have to report on currency, that they take in, things of that nature. So the banks are accustomed to doing this.

I know none of us likes to be a tax collector. Tax collectors are probably among the least popular jobs around. But, nevertheless, I think it preferable that we try to collect what is due rather than impose new taxes on people.

Senator KASTEN. Senator Exon?

Senator EXON. Thank you very much, Mr. Chairman.

I would hope that the committee might be able to institute a policy, Mr. Chairman, if we are going to use the timing device there for the first round of questions, that we also use it for the second round of questions.

I think it might expedite things for the committee and also for the witness. I am going to be very brief.

Mr. Secretary, the opening part of your statement today, which I thought was an important one, that, "It is a pleasure to be able to tell you that the recession now appears to be over, and the fundamental elements of economic recovery are now largely in place."

I hope you are right.

PROJECTS BEING MOVED UP FOR JOBS PROGRAM

My question is: How does that square, if that is true, with the President's recent embrace of a jobs program that 60 days ago he said was simply not in order, we could not afford it, and it was make work?

Secretary REGAN. Well, first of all, even with the recovery we feel that it is going to be a mild recovery at first. There are many economists, of course, who disagree with that. I do not think it will be a more rapid recovery, but nobody knows for sure. And even rapid recovery or slow recovery, there still will be a large amount of unemployment, much larger unemployment than is normal to the United States.

The President had one plan for this. It seems that working with the Speaker and with others, it is possible to bring forward some of the things he was suggesting for 1984 and 1985, when, again, we were saying that we would have high but declining unemployment, so we would bring those plans forward to reduce unemployment faster than had been projected. The President is willing to try that.

Senator EXON. Then are you telling me that essentially the jobs program is merely a moving up of projects that otherwise would have been scheduled for 1984 and 1985, and therefore was not stimulus?

If we are going to go ahead and build these things now, then would not the economy likewise falter somewhat in what we were going to spend in these areas in 1984 and 1985?

Secretary REGAN. Yes, but they will increase the deficit now and make for more stimulus in the economy now, less at a period of time when we are recovering, and as we suggested several times here this morning, cutting the deficits in the outyears at the expense of the deficit this year is not all bad.

Senator EXON. Mr. Secretary, one last question.

Do you think that the dollar is overvalued and, therefore, is contributing to the staggering disproportionate share in our favor with regard to our exports and hurting our balance of trade and, if you think of that, that our dollar is overvalued, how much of this overvaluation is due to Federal Reserve policy and how much is due to others?

MARKETPLACE SETS THE VALUE OF A DOLLAR

What are the plans of the administration to bring the dollar more in line with other currencies?

Secretary REGAN. Well, it is a complicated issue and I will try to keep my answer short, Senator.

Briefly, the marketplace sets the value of a dollar and anyone that says it is overvalued takes a risk that he may be confounded by the marketplace because there are millions of decisions daily as to the value of that particular dollar. The dollar is strong in part because of our higher rates of interest, the strength of the U.S. economy, the uncertainties in foreign economies, and because people are afraid of what is going on in some of the other nations of the world.

There are many who are upset about oil prices and what this is going to do to the local economies. They too are putting their money into dollars.

Accordingly, we have had a large inflow of money into the dollar. This has had a tendency to make it go up. As far as the Federal Reserve's policies, sure, they have had an effect because to the extent that we have been able to bring inflation down, which is to a large extent attributable to our monetary policies over a period of time, this has made for more confidence in the dollar. The fact is that the U.S. rate of inflation is much less than that of some of the other nations of the world.

It is a complicated subject and you could not put a quantitative amount, certain percentage of this, certain percentage of that on specific factors. All of these factors have an effect.

Senator Exon. Well, Mr. Secretary, as Secretary of the Treasury, do you believe that the dollar today is overvalued, undervalued, or valued about right?

Secretary Regan. I can't answer that because the marketplace says what is the value of the dollar, and I have to go with the marketplace judgment. I would say, however, that were the dollar to depreciate somewhat over the next year, I would favor that because I think it would help our exports and at the same time would not raise the cost of living that much in the United States.

Senator Exon. Well, what your answer then does imply, that you feel that the high relative value of the dollar today in the international marketplace is indeed hurting our exports?

Secretary Regan. With that added, definitely, yes.

Senator Exon. And our balanced rates?

Secretary Regan. Yes, sir.

Senator Exon. Thank you, Mr. Secretary.

I thank the chairman.

Senator Kasten. Mr. Secretary, thank you very much.

The committee is adjourned until 2 p.m. this afternoon.

Secretary Regan. Thank you, gentlemen, for your courtesies.

[Whereupon, at 12:22 p.m., the committee was recessed until 2 p.m., the same day.]

AFTERNOON SESSION

The committee met, pursuant to recess, in room 6202, Dirksen Senate Office Building, at 2:30 p.m., Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici and Chiles.

Staff present: Stephen Bell, staff director; Gail Fosler, chief economist; Richard N. Brandon, minority staff director; and Kemble Stokes, chief economist for the minority.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman DOMENICI. I apologize for the delay. There was a vote on the Senate floor. It will be the only vote, so we shouldn't be interrupted this afternoon. I think there will be some members arriving from time to time. I know Senator Chiles will be here shortly.

I welcome to this committee, Mr. Stanley Fischer, professor of economics at MIT, Mr. Donald Fullerton, professor of economics at Princeton University, and Mr. John Kareken, professor of economics at the University of Minnesota. Each of you was invited to testify today because of your substantial research and experience in national economic policy. I am pleased that we have assembled so distinguished a panel.

Before we get into the testimoney this afternoon, I would like to emphasize the importance of the actions of this committee in the next month. Economic policy is not an end in itself. Economic policy, appropriately and prudently set, must lead to economic prosperity, now and in the future.

This is not an easy task. We, the Congress, and the Nation have made many mistakes in the past. In a world which is still reeling from the effects of a sudden and sharp disinflation, the policies that the Congress sets for our own Nation will have great impact, both here and in the world economy as a whole.

GET ECONOMIC MACHINERY MOVING AGAIN

We must get our economic machinery moving again. I am encouraged by the January unemployment data—but clearly the economy is still in a fragile state.

We must get our economy moving and we must hold down the budget. We are in a post-Keynesian world of practical restraints on our actions. The practical restraint is imposed by monetary policy and a national consensus that we must hold the rate of inflation down.

Simply put, this committee must take actions to reduce the deficit that will permit a clearly growth-oriented monetary policy to continue to bring down interest rates. We must do this with special attention to the present needs of the unemployed.

On the surface, these actions appear contradictory. But they need not be. We simply must make serious choices among our current priorities and we must set policies which will bring our tax and spending levels into better balance over the next several years.

I hope that our witnesses today can help us add some flesh to these principles. Should this Nation have a deficit policy, as well as tax and spending policies? How should we set goals for the deficit? How can we separate the cyclical or economic influences in the budget from the more fundamental dynamics of tax and spending programs?

These are a few questions. I am sure that we will have more as the testimony progresses. These questions are not easily answered and I am aware of only the vaguest attempts by the economics profession to answer them. I look forward to your guidance today.

Why don't we start in the order that we have you listed: Stanley Fischer, you can lead off, and then Donald Fullerton, and then John Kareken.

If you have prepared statements, they will be made a part of the record. You can choose to read it in its entirety, or give us an abbreviated form, whatever you like.

The only thing I would say in deference to all three of you is that probably an hour or an hour and a half is about all we can keep people here for, so you do the best that you can within that schedule.

STATEMENT OF STANLEY FISCHER, PROFESSOR OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. Fischer. Thank you very much, Mr. Chairman. I appreciate the opportunity to testify before the committee.

Discussion of the budget is dominated by concern over the size of the deficits projected through 1988. That concern is warranted, for this year's budget is a sober document with predictions that are not—as were those of the last 2 years—wildly unrealistic. If anything, they err on the side of pessimism, underpredicting real growth and overpredicting deficits for the next 2 years.

The administration's budget strategy is to wait until 1985, when the recovery should be well under way, before making any substantial effort to reduce the deficit. I will argue that this is essentially the correct approach. The projected deficits for the next 2 years pose no serious long term problem. Tax increases or spending cuts to deal with them now would be a mistake, slowing down a recovery that is urgently needed. But tax increases or spending cuts or both will be necessary to deal with the long run deficit problem. The administration's proposal for standby taxes to go into effect in 1985 thus points fiscal policy in the right direction.

I shall also argue that the administration's attempt to force cuts in social programs by freezing total Government spending while increasing military spending poses too restricted a choice: the Nation is rich enough to have the social programs it wants along with the defense it needs.

I start by briefly describing the administration's budget projections, and then set them in perspective.

I. THE PROBLEM AND ITS MAGNITUDE

DEFICIT PROJECTIONS

The magnitude of the deficit problem is shown by the administration's budget projections in table 1. The current services budget shows the level of deficits on the assumption that there are no changes in spending programs and tax rates from last year. Without any changes in fiscal policy, deficits through 1988 will average 5.4 percent of GNP, and even by 1988 will be at 6 percent of GNP. The current services budget deficit is a measure of the need for action on the budget.

TABLE 1.—ADMINISTRATIVE DEFICIT PROJECTIONS—PERCENT OF GNP

	Fiscal years					
	1983	1984	1985	1986	1987	1988
Projected deficits, current services budget	6.5	6.5	6.5	6.4	6.3	6.0
Projected deficits, including October 1985 standby taxes	6.5	5.4	5.1	3.6	3.2	2.4

The second row shows the deficits that are projected on the assumption that the administration's budget, including the proposed standby taxes, is adopted. With spending cutbacks, and with the standby tax increase going into effect in 1985, deficits will average 4.4 percent of GNP, falling to 2.4 percent by 1988. There has been no other peacetime period with budget deficits of that magnitude: The closest comparison is with the six Great Depression years, 1931-36, during which deficits averaged 3.3 percent of GNP.

DEFICITS AND THE NATIONAL DEBT

As the deficits continue, the national debt piles up. Table 2 shows the implied ratios of national debt to GNP over the next 6 years. If the administration's budget is adopted, the debt will rise from 30.3 percent of GNP in 1982 to 39.3 percent of GNP by 1986, and then fall back slowly to 38.5 percent of GNP by 1988. If current trends are followed, the debt will continue to rise rapidly, to nearly 50 percent of GNP by 1988.

TABLE 2.—PROJECTED RATIOS OF FEDERAL DEBT TO GNP, IN PERCENT

	Fiscal years						
	1982[1]	1983	1984	1985	1986	1987	1988
Based on deficits on current services budget		34.8	38.3	41.6	44.6	47.4	49.6
Based on deficits after standby taxes	30.3	34.8	37.1	39.0	39.3	39.3	38.5

[1] Holdings of Federal debt outside the Federal Government.

These increases in the debt ratio are large, particularly if there is no budgetary change, but would not take the ratio to levels outside the range of recent experience. Figure 1 shows that the debt to GNP ratio was last at 39 percent of GNP in 1964, and at 49 percent of GNP in 1958.

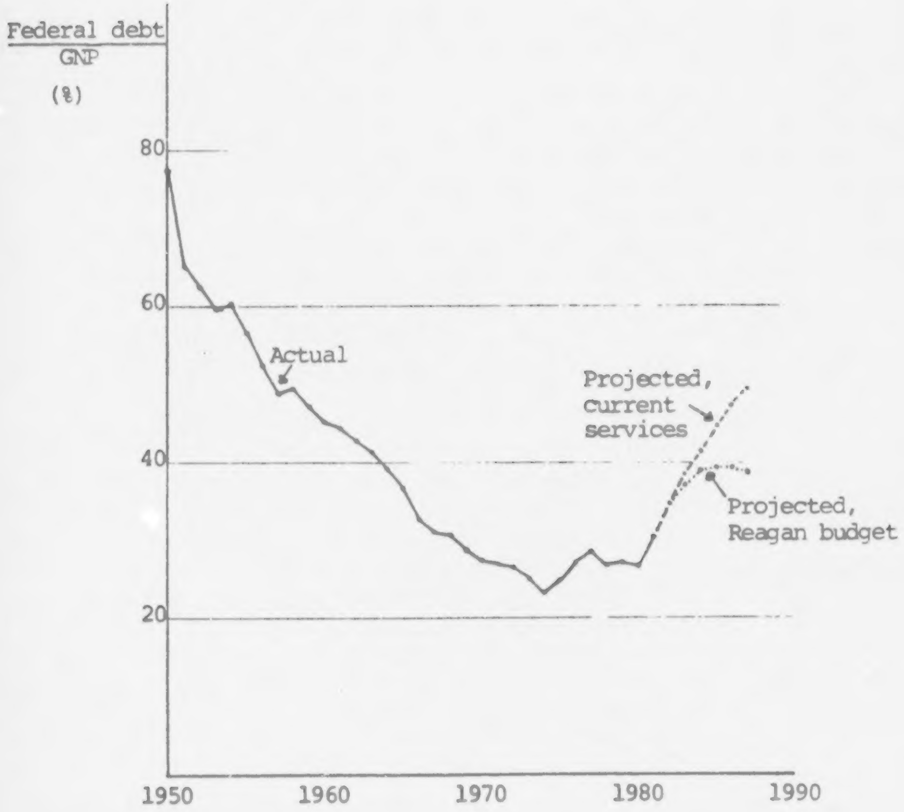


Figure 1: Federal Debt as a Percentage of GNP, 1950-1988.

CROWDING OUT AND INFLATIONARY FINANCE

Deficits are feared because they have to be financed by borrowing, either from the public, or from the Federal Reserve System. If the borrowing is from the public, then saving that could have gone to some other purpose is devoted to the accumulation of Government debt. The most likely other use of the saving would have been to finance investment. Thus the deficits, financed through borrowing from the public, would crowd out investment. Crowding out of investment is accomplished through a rise in the real interest rate in response to Treasury borrowing.

An increase in the real interest rate will to a small extent increase saving, so that the deficit does not crowd out investment one for one. In addition, the higher interest rate will attract foreign capital, providing another offset to crowding out. However, by strengthening the dollar, the higher interest rates reduce export demand.

Crowding out is a problem primarily because by reducing the level of investment, it lowers the level of full employment output, or aggregate supply. At a time when capital is operating at less than 70 percent of capacity, aggregate supply is not a constraint on the level of output. Fear of crowding out should not affect macroeconomic policy at the bottom of a recession of the current magnitude, for we have no problem of being able to produce the output that is demanded. The problem rather is to increase the demand for goods.

If the borrowing that finances the deficit is from the Fed, then the money stock increases, and, it is feared, the inflation rate increases. The Fed can contribute a small amount to the financing of the deficit without creating inflation. At present, the Fed needs to buy about 0.3 percent of GNP in bonds per year in order to inject enough money into the system to prevent deflation.

Thus a deficit of three tenths of 1 percent of GNP could be financed by the Fed without inflationary consequences. Beyond that point, the Fed would contribute to inflation by financing the deficit. For instance, the Fed can finance a deficit of about 0.8 percent of GNP at a 10-percent inflation rate.

But here too we have to make a sharp distinction between the effects of money growth when the economy is in recession and the effects of monetary growth in an economy at full employment. In an economy operating close to full employment, rapid money growth soon leads to inflation. But in a deep recession, with substantial excess capacity and unemployment, the money supply can for a time grow rapidly without immediately igniting inflation.

Thus deficits are much less to be feared when they occur in and as a result of recession than when they occur in an economy at full employment. And the deficits that we face for the next 2 years are largely the result of the recession.

FULL EMPLOYMENT DEFICITS

Table 3 shows full employment deficits corresponding to the administration's budget projections through 1968. The calculated full employment deficits correspond to an unemployment rate of 6.1 percent, and in lines 1 and 2 are based on the conservative assumption that a 1 percentage point reduction in the unemployment rate reduces the deficit by 0.8 percent of GNP. Line 3 shows Data Resources, Inc., projections, which are for smaller full employment deficits, particularly by 1988.

TABLE 3.—FULL EMPLOYMENT DEFICIT—PERCENT OF GNP

	Fiscal years							
	1981	1982	1983	1984	1985	1986	1987	1988
Reagan budget			2.7	2.3	2.8	1.9	2.2	2.0
Current services			2.7	3.4	4.2	4.7	5.3	5.6
DRI [1]	0.3	1.4	2.3	2.3	2.2	1.9	1.5	1.2

[1] Calculated by Data Resources, Inc., February 1983, pp. 1.39 and 1.42.

The current full employment deficit, and that projected by the budget through 1988 is around 2 percent of GNP. This is about 1 percent above the levels that prevailed through most of the seventies, and in the late sixties. The full employment deficit that would obtain in 1988 if no further budgetary actions were taken, would be near 6 percent of GNP, well above historical levels.

Full employment deficits of this magnitude would indeed substantially raise real interest rates. The domestic savings rate would probably increase as a result of the higher interest rate, and a foreign capital inflow would help finance domestic investment. But much investment would inevitably be crowded out.

CONSEQUENCES OF CROWDING OUT

Reductions in investment imply lower capital and productivity growth. A fall in the rate of investment by 1 percent of GNP would in the next year reduce the level of full employment GNP by about 0.1 percent, and in the long run by about 7 percent. This difference between the short and long run consequences of a reduction in investment spending induced through the deficit is significant for guiding policy in the next few years. It means that temporary deficits have only small effects on aggregate supply and output, and are therefore not a major cause for alarm. But permanent substantial increases in the deficit would have major impacts on the level of GNP in the long run.

THE DEFICIT AND THE DEBT

Since a deficit increases the national debt, it would seem that any deficit is bound in the long run to lead to an excessive national debt. This is not so, provided we think of the debt as a ratio to GNP, rather than an absolute amount.

Figure 1 has already shown that over most of the period since 1950, the debt has been falling as a ratio of GNP. To be sure, the debt itself was increasing, but GNP was growing more rapidly. Only in the last few years has the debt grown more rapidly than GNP, and the debt to GNP ratio has therefore risen.

There is a simple relationship between the size of the deficit as a percentage of GNP. That relationship is: Debt over GNP equals deficit over GNP divided by growth rate of GNP.

GNP divided by growth rate of GNP.

For instance, if GNP is growing at 8 percent per year, then eventually a budget deficit of 6 percent per year will result in a national debt that is 75 percent the size of GNP. Given an 8 percent growth rate, a budget deficit of 2 percent of GNP would result in a ratio of debt to GNP of 25 percent, approximately the level of 1973, which was the lowest of the post World War II period. Thus even projected deficits of 2 percent of GNP over long periods would not result in unprecedented ratios of debt to GNP. Indeed, with budget deficits of 2 percent of GNP, the ratio of debt to GNP would fall from current levels.

These calculations depend on the fact that deficits as calculated in the United States include interest on the national debt. Thus if the ratio of the deficit to GNP stabilizes, it is implied that the ratio of the debt to GNP also stabilizes. This means that the Congress has taken steps to prevent the instability that would arise if the deficit exclusive of interest payments were held constant.

II. THE POLICY CHOICES

Crowding out and the possibility of inflationary financing of deficits both imply that deficits of 5 to 6 percent of GNP are not desirable for the long run. Thus by 1988 the deficit should be moved to levels well below those predicted under the current services budget—to 2 percent of GNP or less.

Because the economy is now in a deep recession, and because recovery should be the first priority, it would be a mistake to increase taxes now. The economy needs stimulation, and some of that stimulation is rightly being provided at present by fiscal policy.

Monetary policy too has turned from restriction to stimulation, as it should have. But monetary policy has a narrow line to walk. If money growth becomes and stays too rapid, the Fed reignites fears of inflation. These fears are exaggerated at present, for the economy has much room to grow before the pressure of demand of labor and pressure on capacity brings inflation back. Nonetheless, the Fed cannot ignore the market's fears of inflation, for these immediately affect interest rates and thus investment. But on the other side of the narrow line, if the Fed sticks rigidly to its monetary targets, it may cut off the recovery by allowing interest rates to rise before the recovery is moving.

The Fed's task would be eased if there were assurances that the pressure of budget deficits on demand would be lifted in the next few years. With assurances that deficits would be lower in future, long-term interest rates would likely fall, thus stimulating investment. Monetary policy could do more to stimulate the economy now if it were known that the current degree of stimulus could be scaled down as the economy recovers, without thereby causing real interest rates to rise sharply.

Policy should thus follow essentially the timing set out in the budget projections. Budget deficits should not be reduced through fiscal policy this year or next; rather the first priority is to encourage recovery. Growth rates of output of about 5 percent for the next 2 years are not out of the question, and would not create undue inflationary pressure. As the recovery proceeds, the deficit will become smaller because its cyclical component falls. There is no need to worry about the size of the deficit for the next 2 years because the full employment deficits for those years are not especially high.

Although the Congress cannot bind itself irrecoverably now to take actions in future years, it can affect expectations by giving evidence of its intentions. For instance, it could begin now putting in place the standby taxes that the President recommends for late 1985, such as an increase in the gasoline excise tax. No damage would result from ignoring the administration's description of these tax measures as standbys, since the conditions that are supposed to trigger them will in all likelihood occur.

TAXES AND GOVERNMENT SPENDING

We are in the current budgetary mess for several reasons. The first is the entitlement programs. But the rest is the result of the budget decisions of the last 2 years.

The administration embarked on a policy of cutting taxes and sharply raising military spending. The implications for budget deficits were clear. But the administration chose at the time to make predictions that were incredible to those outside the Government—and that as we later learned were incredible also to those making the projections. One justification for those forecasts was supply side economics, which promised more than could possibly have been delivered.

Another argument that influenced the administration's budget proposals of 1981 and 1982 has not received the prominence it deserves. That is the theory that the only way to cut Government spending is to cut taxes first. The theory then goes that a Congress concerned with deficits will have to cut Government spending. This theory was at least as important in motivating the administration despite the obvious inconsistencies in its forecasts, as was supply side economics.

For 1981 and 1982 the administration proceeded with its program to raise military spending and reduce taxes, interrupted by the 1982 tax increase. Ironically, we were setting out along the lines of the policies that in the late sixties led to increasing inflation when the Johnson administration was unwilling to raise the taxes it needed to pay for the Vietnam war. Only this time the Fed was following different policies.

The consequences have now to be faced. The deficits have to be reduced. This can be done either by cutting spending or by raising taxes. And with the administration committeed to the defense buildup, a decision not to increase taxes will mean further cutbacks in social programs.

Posing the choice as one between military spending and social programs is a mistake. It is possible to have both guns and social programs if we are willing to pay for them. Indeed, it is possible to have guns, social programs, and continued investment.

Such a mixture can be obtained by raising taxes sufficiently not only to cover the higher Government spending, but also to produce Government surpluses. Government budget surpluses would reduce real interest rates and make more room for investment.

Thus if Congress is persuaded by the administration that the Nation needs to spend more on defense, and needs to reduce the deficit, it need not automatically cut social programs. Rather it should ask how much of each the country can afford, and raise the taxes that make them possible.

WHICH TAXES?

If taxes have to be raised, there is reason to begin moving toward consumption taxes, which avoid the double taxation of savings. Such taxes would also make it possible to get rid of the current array of tax exempt savings schemes, and thereby simplify the tax system. Consumption taxes can be made progressive, with higher rates on those who consume more, and I believe progressivity would be desirable. The excise taxes proposed by the administration are consumption taxes but they are directed to specific goods rather than consumption in general.

The easiest way for the Congress to increase taxes would be to repeal the proposed indexation of taxes. I believe this would be a mistake, for two reasons. First, it makes nonlegislated tax increases much easier. And second, we need in general to move toward more, rather than less, indexing of the tax system. I say this because inflation is a long-term problem facing the economy, and one we can ony deal with in the long run by adapting our institutions to minimize its effects.

Of course, no one prefers high to low taxes. But if the country decides that it needs more defense and wants social programs, it can have them, so long as it pays. It can pay by raising taxes, or it can pay through borrowing. Borrowing is appropriate for temporary needs, but explicit taxation is necessary for long run needs.

Chairman DOMENICI. Thank you, very much.

Professor Fullerton?

STATEMENT OF DONALD FULLERTON, PROFESSOR OF ECONOMICS, PRINCETON UNIVERSITY

Mr. FULLERTON. Thank you. I also am very pleased to be here this afternoon.

In the letter inviting me to testify this afternoon, there was a long list of very encompassing questions about the budget. Most of these questions involve the size of taxation in the United States, and I include in this category the third year of personal tax cuts, the possibility of contingent surcharges—although I understand that was stillborn—and even the issue of indexing.

While this emphasis may reflect the interests of your committee, I would really like to emphasize in my initial remarks that it may be important to discuss the way in which we tax rather than the total amount of tax. I would be happy to address the other questions on the budget in later discussion, but I thought I would defer to my colleagues here the macroeconomic issues, for which they have greater expertise.

CORPORATE INCOME TAX IS A CRAZY PATCHWORK

The way in which we tax has important implications for variables such as investment, productivity, growth, the size of the future tax base, and therefore future budget deficits. That is why I think it is important to talk about the manner of taxation rather than just the overall size of it. In particular, I would like to suggest that the corporate income tax accounts for almost all these peculiarities in the way in which we tax, and I am going to cite several examples of these peculiarities. The corporate income tax is basically a crazy patchwork. It has investment tax credits for only some assets, depreciation lifetimes that bear no resemblance to economic lifetimes, accelerated allowances, deductions for interest, no deductions for dividends, and all these things distort choices about what kind of investments are going to be made, where these investments will be put in place, and how they are going to be financed.

Well, these distortions have the result that they decrease the real output of the society. The issue is not just the total amount of investment—we don't have to be concerned with just the total amount of investment—but it is also very important to consider how that investment gets used. If it is put in the wrong place, it won't produce as much as it could if it were put in the right place.

I am going to provide some information that would support the suggestion of President Reagan that the corporate income tax be eliminated, in keeping with Stan Fischer's remarks about switching to a consumption tax.

Well, corporate income tax revenue has been falling in recent years, and it is expected to fall even further as more and more new investment comes to be depreciated under the accelerated cost recovery system. So the revenue is small anyway.

But the elimination of the corporate income tax does not have to mean elimination of even that small revenue, because expensing of only new investment is equivalent to eliminating the distorting tax for new assets only. Expensing provides a considerable investment incentive, but only to new investment. It does not eliminate the revenue that is still to be acquired from the income of existing investments.

This plan would remove the distortions that I mentioned. It would increase the real value of output, and thus increase the general tax base, the real income of the economy, and provide higher future revenue from other sources. That is really the concern when we are talking about future budget deficits.

So now let me elaborate on this patchwork in the corporate income tax.

DOUBLE TAXATION DISCOURAGES INVESTMENT

You have all heard that profits are taxed once at the corporate level, and then again at the personal level when they are paid out in dividends. This is the standard sort of notion that double taxation discourages investment and reduced productivity.

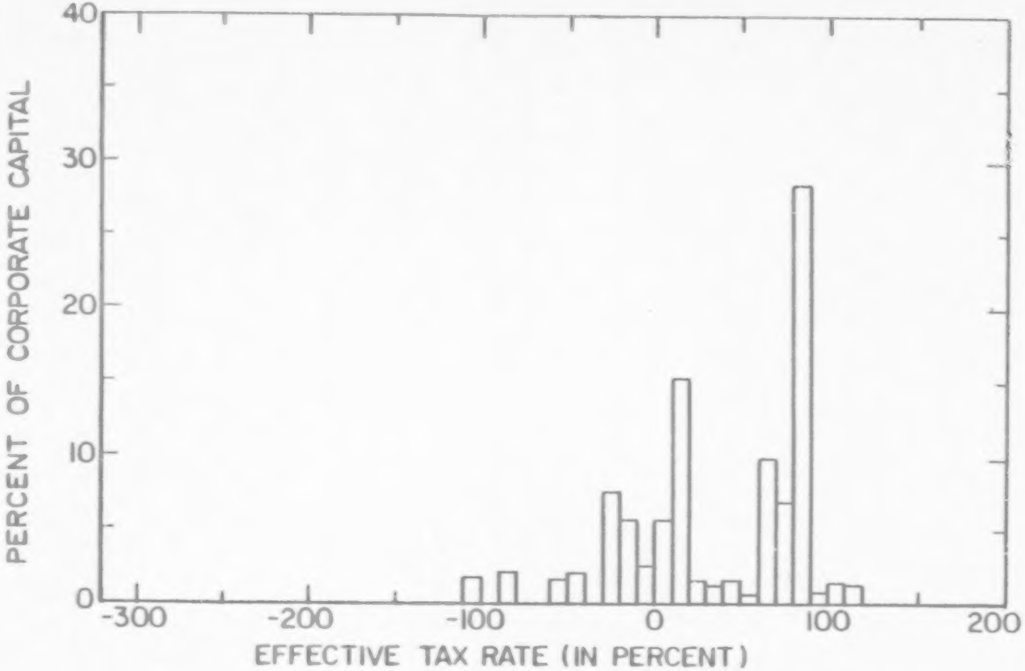
Well, this is certainly true, but I would like to maintain that it is true just for some investments. For example, suppose a corporation buys a new building and finances the project by selling new shares to households. Well, the corporation then would receive no investment tax credit because it is a building. It would receive delayed depreciation allowances, no deduction for any dividends paid to the new shareholder, and the dividends are taxed again at the personal level of the shareholder when they are received. In other research, I have estimated that the total corporate tax, personal tax and property tax on that particular investment that I described can reach 110 percent of the income from the project.

For a different example, suppose the corporation decides to invest in new machinery which gets an investment tax credit, and to finance this machinery by selling new bonds. Suppose, also, that the bonds happen to be sold to a tax-exempt institution such as a pension fund or a Keogh account, an individual retirement account, charity, or university—and by the way, that list is growing.

In this case, the corporation receives the credit, it receives accelerated allowances, and it receives a deduction for all of the interest paid out on the bonds. There is no subsequent personal tax on the interest income if it is received by a tax-exempt institution, and the result is that the tax rate on this project can reach a minus 110 percent.

The diagram which accompanies this testimony shows all of the possibilities in between these two.

THE PROPORTION OF INVESTMENT TAXED AT EACH RATE IN THE FIXED - p CASE
FOR THE U.S.



From Mervyn King and Don Fullerton, editors, The Taxation of Income from Capital: A Comparative Study of the U.S., U.K., Sweden, and West Germany, Chicago: The University of Chicago Press (forthcoming).

The height of each bar in this diagram shows the amount of new investment that is likely to be taxed at each rate. As you can see, not that much new investment is taxed at rates over 100 percent, but almost 30 percent of new investment is likely to be taxed at rates between 80 and 90 percent. That is the height of the highest bar within the diagram.

Not that much investment is taxed at rates below a minus 100 percent, as in the example I just described, but plenty is taxed at rates less than zero, because of the interest deductions, accelerated depreciation allowances and credits.

EFFECTIVE TAX RATE GOES UP WHEN CORPORATE TAX IS ELIMINATED

The corporate tax system, therefore, subsidizes a substantial amount of investment, and that implies a considerable loss of revenue. By the way, when I average these different tax rates together, I get an overall effective tax rate, under the new 1982 law, of 31.5 percent. That is an average of rates that extend up to more than 100 percent and down to less than, minus, 100 percent. And that average of 31.5 percent includes corporate taxes, personal taxes, and property taxes on the average new investment.

Here is the surprising part of my findings. When the corporate tax is eliminated, this effective tax rate of 31.5 percent goes up to 35 percent. What is happening here is that the combined effects of the credits, accelerated allowances and interest deductions more than offset the corporate tax. The average new investment is subsidized at the corporate level, and the only reason there are still corporate tax revenue receipts is because of tax on the income of the old assets. Even that income from the old assets is being reduced by the net subsidy that is provided for new investment.

The justification for each of these features really warrant another look. Why does Government want to encourage machinery through the investment tax credit when that additional machinery comes at the expense of adding new buildings instead, or inventories instead, or other intangible investments in R&D, or goodwill through advertising?

Why does the government know more than private firms about the mix of assets that they should use? I really think that private firms should be insulted by the implication that Government knows more than they do about the proper investment plans. I just find it difficult to justify the investment tax credit for only some investments.

It would be difficult to eliminate these credits under the existing corporate income tax, but not if the corporate tax was eliminated through the vehicle of expensing that I mentioned a moment ago.

ACCELERATED DEPRECIATION ALLOWANCES

Next, let's look at accelerated depreciation allowances. They have been justified as a response to high inflation which decreases the real value of allowances based on historical costs. ACRS' which has just been enacted in the last couple of years, has the appeal of simplicity, since it has only four categories of investment lifetimes. The problem is that assets actually wear out at more than four different rates, and the result is further misallocation of the capital stock. There will be too much of assets that are given a lifetime shorter than the actual lifetime, and there will be too little of other assets that are given a lifetime longer than the actual lifetime.

If all these assets were immediately expensed, as I am suggesting, there would be no such misallocation, and no effects of inflation.

DEDUCTION FOR INTEREST PAID IS JUSTIFIED

Finally, the deduction for interest paid is justified as the natural counterpart of the tax on interest receipts. Certainly, if you are going to be taxed on interest receipts, you ought to be taxed on net interest receipts, and that means the deduction for interest paid.

Yet a growing proportion of interest receipts are not taxed. More and more savings are flowing through these individual retirement accounts, pension funds, and now the new educational savings account. If we lower the tax on interest received, then at some point in this process we must break from the practice of allowing deductions for interest paid.

Otherwise, we could end up like the United Kingdom, in the study I just mentioned. This study was an international comparison of taxes in four different countries. Britain allows the immediate expensing of new machinery. There are regional grants (which amount to investment tax credits) for machinery in addition to this expensing. Interest is still deductible, so that if you had an investment in machinery in Britain that was expensed and got a credit and the interest was deducted, and if that interest went to a pension fund, the total effective tax rate on that investment would reach a minus 300 percent.

I guess I would like to suggest that Britain is not an example we want to be following in that regard. That would just mean breaking from the practice of taxing interest income as well as allowing deduction, because it is the deduction that makes the span of that diagram so wide.

Well, clearly, I have been arguing for a consumption tax operated by the vehicle of expensing under the corporate income tax. As Stanley Fischer was saying, if this tax was operated by having individuals include all forms of income and then deduct all forms of savings, the remaining tax base could be taxed at rates that are as progressive as you like.

I don't mean to make claims about the proper distribution of income, or about the way in which high income individuals ought to be taxed or low income individuals ought to be taxed. I know that you are concerned about equity in taxation generally, and in the corporate income tax in particular. I think the way to achieve equity is through the personal rate bracket under a consumption tax, a comprehensive consumption tax.

TURNING POINT IN TAX POLICY

So, just in summary, I think we are at a turning point in tax policy. In the past 15 years or so, Congress has been concerned with ways to cut taxes because inflation kept pushing people into higher brackets and increasing revenues, and Congress had to find ways to offset that. Now, all of a sudden, Congress is concerned with ways of increasing taxes instead, and it is a much more painful state of affairs.

But it does present us with a unique opportunity, I feel, for some substantial tax reform. Substantial tax reform cannot be accomplished by tinkering with the third year of rate reductions or contingent surcharges or even indexing. These changes do not address the very pressing problems that I have tried to describe in this testimony.

Thank you.

Chairman DOMENICI. Thank you very much.

John Kareken, professor of economics, University of Minnesota.

STATEMENT OF JOHN KAREKEN, PROFESSOR OF ECONOMICS, UNIVERSITY OF MINNESOTA

Mr. KAREKEN. Thank you.

I am pleased to have been invited here, and I think I will depart from my statement. It will take me only a couple of minutes to tell you more than I know.

I am reminded, by the way, in the consumption tax discussion, of a remark by Kenneth Bolding, "What did posterity ever do for us?"

Well, the preoccupation is clearly with deficits, and we are agreed, I think, that cyclical—so-called cyclical deficits—are not a problem. They are simply a comment on the economy, and they describe how much built-in flexibility and other arrangements have put into the economy.

STRUCTURAL DEFICITS ARE INFLATIONARY

Most everyone is agreed that if there is a problem, it is with the so-called structural deficits, which I take to be another name for the high-employment deficit, and we are probably well advised to have changed the name since the old name used to excite passions.

I happen to believe that structural deficits are inflationary one way or another. You will get inflation out of a structural deficit. There are those who will tell, the esteemed Undersecretary of the Treasury, for example, and other ultramonetarists will tell you that deficits don't matter, and they will present a lot of scatter diagrams and say, "Where is the correlation between inflation and deficits?" and all one can say to that is that their naivete is touching.

What you have to do is decompose budgets, the actual budget deficit into the cyclical and structural components. No one has done that yet, and it is very difficult, but no one has done it, and so all of these studies, all of these scatter diagrams that purport to show that deficits have no effect on anything, they are simply at best a waste of time and paper.

I don't say that the case that deficits are inflationary has been made, but certainly the opposite case has not been made. The evidence that has been presented is primitive—almost beyond belief.

There is not, so far as I can see, any great mystery about why deficits are inflationary. Under certain conditions, the Federal Reserve has to monetize the debt simply to keep the economy from exploding. If you try to finance a deficit with bonds and then the next year you try to finance the deficit plus the interest that you owe with bonds, and then the next year you try to finance the deficit and the interest and the interest with bonds, if the interest rate, the real interest rate, is positive, that just means an explosion and insolvency, and literally forces the Federal Reserve to monetize the debt to prevent insolvency.

Another way of saying that is, of course, the Federal Reserve could drive the real interest rate negative to avoid Government insolvency.

There is also the problem in different circumstances Stanley Fischer referred to of crowding out, which I take to be a serious one, and in the long run inflationary.

We are clear that what we are dealing with, and so many calculations have been made that we are clearly dealing with a structural deficit, and if I were to part company with Stanley it would be in his unwillingness to do anything about that over the next couple of years.

As I look at it, so many promises have been made by Government and not kept that to have a tax imposed a couple of years down the road amounts to nothing.

If you are going to be credible, you either announce that you are going to do nothing, or you do something in the present. I am not at all clear, although it takes some imagining, that in the short run interest rate effects don't overbalance any demand expansionary effect.

I think it is fairly easy to come to an opposite conclusion than the one Stanley came to about the harmful effects of doing something about a deficit in the immediate period.

But the big thing is that credibility is so important that if you are going to take the deficit seriously, if you are going to take inflation seriously, then you have to do something about it now.

AIM FOR ZERO DEFICIT

As near as I can see, the target that you ought to aim for is a zero deficit, structural deficit. I see no reason whatsoever for being content with CBO's 2 percent of GNP as a long-run target, and I think that the sooner you can get there, the better.

The question of how you get there, I am happy to say, is your job, not mine. You folks being the arbiters of income distribution and things like that, one thing I would say—two things, if I may: One is that it seems to me we are in danger of doing funny things to our tax structure. We got into this problem with a big cut in the income tax, and now the Congress in attempting to deal with that problem is raising different taxes, imposing uncertainties here, and it is not clear that there is any design in what is being done to the tax structure.

That, it seems to me, is a concern.

The other point is that, like Stanley, I can see some reason for putting off the 1983 tax cut, perhaps forever. I can see no good reason for repealing indexation. I agree that we need more indexing, not less, and finally, just because they have dragged the consumption tax in, the wet cat, I don't see any great justification for consumption tax. Why you would want to distort the savings-consumption choice rather than the labor-leisure choice, I just think they are whistling.

Thank you.

Chairman DOMENICI. Thank you very much.

PREPARED STATEMENT OF JOHN KAREKEN, PROFESSOR OF ECONOMICS, UNIVERSITY OF MINNESOTA

It is an honor to have been invited to be here this afternoon; and my fondest hope is that, being here, I will somehow manage to say something that someone will find helpful.

At this moment nearly the entire Congress is preoccupied with the federal budget, and the outlook being what it is, I am going to content myself with a few homely observations about budget deficits. The first, about as homely as could be imagined, is that we cannot get by without distinguishing between "structural" and "cyclical" deficits. If I were king, I would order "policy" substituted for "structural." But whatever one's tastes in adjectives, a distinction is essential. Fortunately, many of us are agreed on that.

A cyclical deficit, being attributable entirely to the state of the economy, is not a problem. Along the way there will be a more or less matching cyclical surplus, also attributable entirely to the state of the economy. Over a business cycle, from peak to trough and back again, cyclical deficits and surpluses add to zero. By definition, they must. Of course, actual deficits and surpluses need not add to zero. Deficits may, for example, be larger on average than surpluses. If so, there is a structural deficit. And such a deficit may well be a serious problem. That depends on how inflation is regarded, whether with a certain dispassion, as one among many taxes, or as a destructive evil that cannot be tolerated. In either event, inflation is what results from a long-term structural deficit -- or from a near-certain prospect of budget deficits persisting year after year into a far-distant future. That, it seems to me, cannot reasonably be disputed.

There are those who, if here, would think me crazy. Our esteemed Under Secretary of the Treasury has said many times that budget deficits are not inflationary. One has to wonder, though, what that assertion is supposed to mean. As I observed earlier on, it is necessary to distinguish between structural and cyclical deficits. So are we to interpret the Under Secretary and other ultra-monetarists as saying that even a long-term structural deficit is not inflationary? If so, they are contradicted by present-day economic theory.

The ultra-monetarists are fond of pointing to the past and claiming, with what can only be regarded as a touching naivete, that it does not reveal budget deficits as being inflationary. It does not show the rate of inflation having increased whenever the budget deficit increased. But no one should ever have expected the past to show that. For one thing, the question is whether a long-term structural deficit is inflationary. And that sort of deficit is something quite new to the United States.

There is a further point. To get at whether a structural deficit is inflationary, one has to do more than simply look at actual budget imbalances and rates of inflation. It is necessary, before looking, to decompose actual imbalances into their cyclical and structural parts. That may not be easy to do. Nevertheless, it is necessary. Unless actual budget imbalances have been decomposed, there is no way of making anything of what has been found out.

Imagine an economy in which tax receipts are highly sensitive to total output. If it is also imagined that government spending is constant, then over the business cycle the budget imbalance swings wildly. And imagine that the price level is also sensitive to total output. It decreases, if perhaps only a little when total output decreases and increases when total output increases. What then do we observe? For one thing, a rate of inflation that decreases as the budget deficit increases. It hardly follows, though, that an increase in the long-term structural deficit is deflationary. To conclude that -- or, indeed, anything about a change in that deficit -- would be ludicrous.

There is no mystery about why, even if bond financed, a long-term structural deficit is inflationary. To prevent government insolvency, the Federal Reserve may have to monetize a greater and greater proportion of the bonds issued by the Treasury. And with no monetization the real interest rate must increase. So investment decreases, and as a result there is a decrease in the limit on future output of goods and services, but with no corresponding decrease in demand. Nor, finally, can we dismiss out-of-hand that the so-called financial services industry will innovate (as it did, for example, by introducing money market funds), thereby making government bonds more like money and increasing the rate of inflation.

A great many experts have done the required calculations, and we are therefore reasonably sure that those large budget deficits of fiscal 1984 and beyond are not entirely cyclical. We are a little way into what can be regarded as -- or, as I believe, has already been perceived as -- a new budget policy. The record, if not the thetoric, indicates a shift to a greater long-term structural deficit. Thus, unless the Congress wants the inflation rate to increase again, it must do something.

There are two questions. As the CBO has made plain, the Congress has many deficit-reducing options, all economically if not politically feasible. But which to choose? And the second question is how the structural deficit should be made to change over the years immediately ahead. Or, to be more explicit, what should the target value for the structural deficit be? And how quickly, over how many years, should that target value be achieved?

Although I do not want to seem cowardly, I do have to insist that those questions are much more political than economic. They are to be answered by our elected representatives, those of the Congress and those of the Administration, not be me or any other economist. I might perhaps feel a little differently if I thought that economists knew anything about the economic consequences of inflation. But near as I have been able to determine, they do not. Those who say that inflation is just a tax are only whistling; and so are those who say that if only a little inflation is tolerated, the end must be hyperinflation and ruin. No one would deny, though, that inflation is a tax, possibly an especially pernicious one, but a tax nonetheless, and it is for our elected representatives to decide how much to rely on it. More generally, it is for those representatives to decide who should benefit from government spending and who should they be paying.

Having said what I did, I should stop. I did want, however, more as a citizen than as an economist, to end with two brief observations. The first is that I have extreme difficulty with any target value for the structural deficit other than zero. It is simply that with a zero target value, the electorate must in effect vote on whether it wants more or less government spending. All taxes are explicit.

The final observation is that we seem to be changing our tax structure, but, as it appears to an outsider, without an overall plan -- and with no great concern. We got to where we are by decreasing (effective) income tax rates. Since the decrease was affected, though, the Congress has been busy increasing this tax rate and that. And if it goes on as in the recent past, who knows what sort of tax structure will have been wrought. Or possibly it is that someone does have a pretty good idea.

Thank you.

Chairman **Domenici**. Senator Chiles?

Senator **Chiles**. I note, Mr. Fischer, you are talking about there being no problem with these deficits for the next couple of years, but you see great problems with structural deficits after that.

We will have these high deficits for the next couple of years if we don't do anything about blocking and building in structural deficits in later years. We have got interest that is going to increase $47 billion, additional interest we will be paying in 1988 because of the debt we are building up over here.

If we don't do anything about this, aren't we locking in the structural deficit?

Mr. **Fischer**. Senator, I would agree with you that if we were talking doing nothing through 1988, we would be adding—we would be creating—a very serious long-term problem. I was thinking about the next 2 years. That is a substantial amount that will be deficits which will total $400 billion, which will add about $32 or $33 billion to interest.

That is a large amount, I agree, but I wouldn't think it would be wise to wait any longer than that to start acting to get rid of those deficits.

What I am afraid of is that tax increases in the next 2 years would run the great danger of cutting off the recovery.

TAX DECREASE NOT A GOOD IDEA

Senator **Chiles**. I always listen to the rhetoric about a tax increase. Do you think it is sound economic policy to enact a permanent tax decrease of 10 percent at a time that you are sitting with a $200 billion deficit? Because that is what we are getting ready to do July 1. It is not a tax increase we are talking about. We are talking about whether we are going to give a further tax decrease of 10 percent.

Mr. **Fischer**. Senator, the decreases that were being suggested by the administration were decreases of what would otherwise be increases: We are not cutting taxes back to the late 1970's by cutting taxes in July.

So it is true if we repealed the tax cuts, we would have more taxes and lower deficits. I don't think at this time that is a good idea.

ECONOMY RECOVERING IN SPITE OF POLICIES MADE

Senator **Chiles**. Well, and I listened to all of the so-called rational explanations of why we have to have this additional stimulus now. It looks like, to me, the economy is recovering in spite of everything we have done to it; all the injuries and everything else, and I don't think it is recovering as a result of any policy that we have made. It is recovering in spite of policies we have made. It seems like to me, there is economic recovery, this plant pushing up its little buds and trying to get its head above the soil and the best thing to do to keep it alive is not add to these massive deficits, and the potential of higher interest rates.

If we did anything, when interest rates broke last year, it was when we had a tax increase. We added some money, and when the Fed formula loosened up on the money supply, those two in combination, seem to have been the signal that caused interest rates to come down. If the economy is doing anything, and it is in my State with housing, it is simply because those rates have come down.

If those rates could come down a little more, or if the people felt for sure they were going to stay down, I think we would have a recovery.

I don't think the tax cut has a dadgummed thing to do with it now. I think it is people's concern about what that interest rate is going to be.

Mr. Fischer. Senator, I think that is right, and I think the interest rate they are worried about is the long-term interest rate. It is the mortgage rate, the rate for firms which are going to borrow for undertaking investment.

Senator Chiles. All right.

Mr. Fischer. That is the rate that has not come down very much in real terms.

Senator Chiles. Why?

Mr. Fischer. Why? Because of these long-run structural deficits.

Senator Chiles. That is exactly right.

Mr. Fischer. Right.

PUT IN PLACE TAX INCREASES

Senator Chiles. Inflation expectations. All right, How do you get that down?

Mr. Fischer. You put in place tax increases that come into effect as we come out of this recession.

Senator, when you say that we are coming out of it, we are recovering, which is true, we are recovering from an incredibly low level, and we were recently, and we still are, at the worst place we have been since 1941.

Senator Chiles. Because it looks like the interest rates are going to stay high. I mean, everybody I have heard that says it is going to be a slow recovery, is saying it is going to be slow because the interest rates are going to stay high. How in the hell do you get those interest rates down?

Mr. Fischer. That is why we need to have some assurance that in the long term after recovery gets moving, the deficits will be reduced. It is the long-term interest rates that are the serious problem.

Senator Chiles. Well, let me ask you this. You have looked at the administration's numbers—and I ask this to the panel—with a structural deficit, and they end up with $117 billion that is all structural in 1988, over 2 percent of GNP, is there any way that you can end up at the time that you are in full employment with that kind of a structural deficit and have the inflation numbers that they are projecting, that inflation is going to stay down?

Mr. Fischer. My view is that you can, with the appropriate monetary policy.

Senator Chiles. All right. Let me ask you this: Is there any way you could have the appropriate monetary policy to keep their inflation at the level they are talking about with that size structural deficit, is there anyway you can do that and have the kind of recovery they are talking about, 4-percent average, 5 years in a row?

Mr. FISCHER. Yes, Senator, I think there is, provided the structural deficit——

Senator CHILES. Then you believe in the tooth fairy.

Mr. FISCHER. No; I don't believe in the tooth fairy, Senator. I thought the administration had tooth fairy stories for the last 2 years, but I don't think this budget is a tooth fairy story.

Senator CHILES. I would like to hear from you, Mr. Fullerton.

Mr. FULLERTON. I was interested in your eloquent remarks arguing against the need for a tax cut. You argued that any change in the tax system, in the overall size of the tax system, at this time would just mess up the recovery that is now underway.

If I could just turn the tables a little bit, that sounded also like an eloquent argument against any kind of tax change, including tax increases as well as tax cuts. I wonder if that meant that there was a good argument for instituting indexing right away. That is, avoid the 10-percent tax cut, but institute indexing right away to keep inflation from increasing tax rates which then might in itself proceed to mess up the economy, that is already on its way to recovery.

Senator CHILES. I am looking at that deficit in 1988. Under the best of their projections, which would be a 4-percent recovery 5 years in a row, and I am trying to figure, is there any way you can get there from here without having revenue, and without having that revenue as soon as you can get it.

Mr. FULLERTON. I thought that was a good argument against the tax cuts. Actually, I haven't formed a strong opinion on whether we ought to have the third year of the personal tax cuts. But your argument to me was an argument for immediate indexing, as you said, without the need for the immediate 10-percent tax cut.

We don't want to have unlegislated tax increases year after year, which rely entirely on the whims of whatever inflation rate happens to takes place.

WE HAVE TOO MUCH INDEXING NOW

Senator CHILES. Again, let me say I agree with you in theory. I love the idea of having tax indexing, and I think if we were sitting here with a balanced budget and we were talking about how to restrain the Congress spending, tax indexing would make a lot of sense, but if you are sitting here with the kind of deficits we are talking about and you are talking about a way that we are going to limit income coming into the Federal Government at a time when you are not limiting—you know, it would be nice if we could index weapons systems so they don't go up. If we could index the food stamp payments and some of the others, we would index the other way.

You see what a couple of you said is that you are for more indexing. Our problem is that we have got too damned much indexing. We are adding more.

We have indexed our costs to increase outlays, and now we are increasing our revenues to decrease what we are going to get in. We have got the worst of all worlds.

Mr. FULLERTON. Senator, revenues would already be going up with price levels. If it was pure inflation, incomes would be going up at the rate of inflation as well as cost, and so with indexing in the tax system, the revenues would be going up at the same nominal rate.

The problem with bracket creep is that the tax rate actually increases. Taxes take a higher percentage of a higher nominal income, rather than the same percentage of a higher nominal income, which would give you the required revenues for making expenditures where the costs are going up at the rate of inflation.

Senator CHILES. Well, but look what you have done from the standpoint of the Government, in regard to our revenues, with regard to the money we have to deal with programs. When we have to in effect—what you are saying is that you eat inflation on every program that you have.

Mr. FULLERTON. It is not an argument in favor of inflation. It is an argument in favor of living with inflation as best we can, and an argument in favor of legislative tax increases. If you are worried about deficits and tax revenues, I would suggest that you pass a bill, if you like, to repeal this third year of the personal tax cuts and then pass every bill that is required to get sufficient revenue. Do not leave the tax increases in an unlegislated way.

Senator CHILES. Any place that we can reach where we don't have a structural deficit, I will be for indexing right away, but as long as I see that we are going to have that, then I think that we are just compounding a program.

I would like to hear from you.

DO SOMETHING ABOUT THE DEFICIT NOW

Mr. KAREKEN. I can be very brief. I think that with the exception of your comments about indexing, I think your questions were better than Stanley's answers.

I don't believe that you can do anything about today's expectational effects by promising a tax increase in 2 or 3 years, and it is by no means clear that a reduction in the deficit doesn't do more for expansion than the traditional stimulative effects that Stanley refers to of Government spending and tax reduction.

So I have no trouble with doing something about the deficit now, even though there are these concerns about the effect of changing taxes and the effect of cutting spending on the recovery.

It is just a long way of saying that the question was a good one.

Chairman DOMENICI. I don't have very many questions. Frankly, other than your testimony, Mr. Fullerton, which I greatly appreciate because it contributes to my understanding of tax dynamics, I have heard most of what the other two gentleman have had to suggest from time to time in the past couple of years.

It does seem to me that there is a growing consensus that the 1983 deficit, and the 1984 deficit, the real one that we know is 1983 and the one projected in the administration's budget, are not the problem.

I think I got consensus out of that, unless Mr. Kareken in his last statement was saying that maybe we ought to try to dramatically reduce even the 1984 deficit. You didn't intend that in your last statement?

Mr. KAREKEN. Well, I certainly agree that there is a great, big cyclical component in that.

Chairman DOMENICI. Yes; actually, I really don't think that there is as much disagreement among all of the experts that we have heard from, notwithstanding what my good friend Senator Chiles has said about getting the deficits down.

I think almost everyone is saying what we need is a fiscal policy and a monetary policy with 4 or 5 years of predictability, and that is where we are in a jam, because we could easily, I think, in this committee, come up with a 1984 budget. I think we would argue around for maybe 2 or 3 days about the size of defense for that particular year, resulting from the budget authority we gave, and we would probably leave all the taxes in place for that year, and that would be a pretty good indication for that particular year that we will come out with a $180 billion deficit, because the economic assumptions on the growth side, if anything, are moderate and modest.

The problem is that without significant changes on the expenditure side and the tax side, the deficits are predictably going to go higher rather than lower, even with real, sustained growth.

And that is where we have trouble as to our kind of budgeting, and the fact that we are basically conducting business on an annual basis. That is where we have trouble.

STANDBY TAX BEST MEDICINE

Frankly, I am the only one around, I think, that has said that the standby tax, in notion, is about the best medicine around.

Can we convert it into something we can do up here that will indeed convince people that if that deficit is that large in 1986, 1987, and 1988, that there will be in place a tax change that will yield some significant amount of revenue to diminish the deficit—the expenditure reductions recommended—and do those on a multiyear basis?

Frankly, I think it is a very simple proposition, probably as clear cut as we have had in years.

But for foreign banks and foreign countries that we can't figure at this point, I think there is a clear picture, at least in this Senator's mind, of how we can get out of this mess and stay on a very strong course of recovery.

The problem is, how do we get those 3- and 4-year predictabilities into the budget, and how do we get a tax policy in place now, in the next 3 or 4 months, that leaves alone 1983 and 1984, and yet changes the base in the outyears?

Maybe I am oversimplifying it, but I really don't see it as being very complicated, and I don't see one tax versus another in the outyears as being very significant.

If you deferred the indexation for 3 years and left it on the tax books, I don't see that much difference between that and a 5-percent surtax that the President says we ought to put on.

I understand that technically you will have a different base 3 years hence, but the tax road is an ever-changing thing. If you study it, it is not intelligible as to why a lot of those things were put in the corporate structure.

So let me just stop at that point and see if any of you have any comment?

CREDIBILITY IS KEY QUESTION

Mr. FISCHER. Yes, Senator. I think that there is substantial agreement on the next 2 years and on the need to put something in place to get the deficits down later, and I fully appreciate the key point is the one you raised: Is there anything credible that can be done that will make those standby taxes or something like them be believed by the financial markets?

I think that is the key question: I don't know very much about this. It seems more like a legislative question, but I have the impression that to take an example of the July 1983 tax change, that when the Senate has gone—the Congress has gone—to the trouble of putting through a bill with a lot of difficulty, that that tends to have some momentum behind it, and that if the Senate went ahead, actually, or this committee went ahead and proposed those standby taxes, the mere fact that they were there and legislated would stand for something.

Obviously, they wouldn't be the same as an ironclad guarantee, but the fact that the 1983 tax cut is in place, and it looks very unlikely that it is going to be taken out, suggests that when legislation is on the books it has some effect.

As to the other issue, indexing versus consumption tax, I think that on the basic point, you are right. If the choice is between nothing and the deferral of the indexing, then deferral of the indexing is correct, but I do think that there is an important longrun inflation problem, and that continued deferral of indexing is going to mean no indexing, and that we need more of it in both the personal income tax and in the corporate income tax.

REAL RATE OF INTEREST HAS VARIABILITY

Chairman DOMENICI. Let me ask one question along the same lines.

We hear so much about inflation expectation being a driving force behind the real interest rate disparity, which is obviously a very strange anomaly at this point, to have a 7-point real interest rate for a long period of time. We just have not historically had that. In fact, we have had periods when the real interest rate was negative, in the decade of the 1970's.

I am not suggesting that was good policy for those who invested long term for their clients. If they are still hiring them, they have got dumb people hiring them, but it appears to me that everybody is predicting we have done something different and inflation is not nearly the problem in the future that it has been in the past, and yet we continue to hear that it is the inflation expectation that drives these real interest rates.

Am I missing something? I see nobody projecting inflation back up at 14 percent 3 years hence under any scenario, or 15 percent.

Mr. KAREKEN. All right. I am sure that inflationary expectations are important. Some of us make a living out of that sort of thing.

But I don't think you can, when you talk about the real rate of interest, Professor Friedman's 3 percent is pretty much a fiction, and there is a lot of variability in the real rate of interest, and I don't see why you should ignore the deficits and expectations of deficits when you are confronted with a high real interest rate.

I mean, economics would predict that these deficits, present and prospective, would give you a high real rate of interest. That is what we talk about with crowding out. So——

Chairman DOMENICI. Let me assure you that I am not suggesting that we ignore them.

Mr. KAREKEN. No.

PRESIDENT'S BUDGET NOT A CREDIBLE ONE

Chairman DOMENICI. Let me put the question very simply: If you took the economic assumptions that the President has made in his budget with reference to growth and inflation for the next 5 years, and thus you expected a $5 trillion economy in 1988, with a starting point of a deficit in 1984 as we know it, but if it really was going to go down to $100 billion, with those economic facts that I have given you, would that deficit be too big?

Mr. KARAKEN. Well, I think that any structural deficit above zero is too big.

Chairman DOMENICI. All right. Would it have a serious impact on inflation, in a $5 trillion economy 5 years hence with the assumptions in the President's budget?

Mr. KAREKEN. Well, I don't know that it would have a lot. You are getting down to, you know, a reasonable percentage of GNP.

Chairman DOMENICI. What do you think?

Mr. KAREKEN. I just don't think you can get there from here. I tend to agree with Senator Chiles that the story that has unfolded in the President's budget is not a credible one.

Chairman DOMENICI. Which part?

Mr. KAREKEN. Well, that you can have that real growth, and that little inflation and that size budget deficit. If you don't do something about the deficit, you are not likely to have that strong an economy, and you are also probably underestimating inflation a little bit.

Chairman DOMENICI. What do you think?

Mr. FISCHER. I think the $100 billion projected deficit is consistent with the low rates of inflation they predict, and I think the reasons the rates have not come down yet is that the markets really do not know that that is going to be the deficit.

Chairman DOMENICI. I would say to you, Mr. Kareken, I don't see how we can get it down under that without a tremendous increase in taxes, just knowing the propensity of Congress on the cutting of the expenditure side, and the almost unanimous idea up here that we have got to increase defense. It is just a question of how much—and I don't know 5 percent in either body that wants to literally cut defense. They are only talking about how much should the increase be reduced.

With that given, I don't see how we can get below that $100 billion mark without very significant tax increases well beyond anything I can imagine anybody would think is good for the economy.

THE QUESTION IS WHAT TAX TO USE

Would that concern you, that we would get below that? Is there any level of taxation that would be too high a penalty to pay to get below the $100 billion mark by 1988?

Mr. KAREKEN. Well, it is a cowardly thing to do, but I would just rest with the statement that any gap between what you spend and what you take in has to be taxed away from the public in the form of inflation, and it is not a question of taxing people less, because you are going to spend more for military, or taxing people more. It is only a question of what tax, and it is a question of income tax versus or something like that, because those productive resources that you are using in this military spending and that sort of thing, that generates claims upon income, and that has to be taken away from the public one way or another.

And so it is a question of the form of taxation only, inflation versus explicit taxes.

Chairman DOMENICI. Then you would think that whatever the form, standby tax or deferring the indexation or some combination, you would think that there is a great risk of inflation if we are on the budget trend line that the President recommends going from the present deficit down to 100 by 1988?

Mr. KAREKEN. Well, I think that there is clearly something in what Stanley says, that when you put something on the books, you put in a lot of effort, and that creates some inertia.

So I wouldn't dismiss a standby or contingency tax entirely.

For the sake of credibility, I would prefer that you do something right now.

Chairman DOMENICI. Strike the standby. I am asking you, if we put in place taxes equivalent to those the President asked for in his budget, and we moved the budget trend line down toward $100 billion in 1988—forget the standby; it is in place—you think there is a very serious risk of inflation on that kind of trend line nonetheless?

Mr. KAREKEN. Yes.

Chairman DOMENICI. What do you think?

Mr. FISCHER. I don't have any trouble with keeping the growth rate of money at a reasonable 8 to 10 percent rate over that period.

SPENDING MONEY FOR JOBS

Chairman DOMENICI. I didn't ask any of you this question before, and this is my last one.

You hear a lot of talk now about us passing legislation to create jobs, to spend money for jobs. Is now the time to spend money for jobs?

Mr. Fischer?

Mr. FISCHER. Senator, I think anything that could be done to get the interest rate down by just a little bit would be more important in its effects on jobs than would the jobs program of the magnitude that is currently being proposed.

Chairman DOMENICI. Mr. Fullerton?

Mr. FULLERTON. I guess I would think that the time to spend money for jobs was about 6 months or a year ago. I am not so sure now, but I think it is still warranted given the unemployment rate.

Chairman DOMENICI. Mr. Kareken?

Mr. KAREKEN. I certainly agree with what Stanley said. I think with a jobs program you risk undoing—we have paid a tremendous price in unemployment and things like that, and if you now begin to respond in a way that has been so typical over the postwar period, do that again, you will have lost a good share of what we have gained in this attempt to beat inflation.

Chairman DOMENICI. Well, I hope that $100 billion by 1988 does not create a very adverse economic climate, because frankly, from everything I can see, it will be extremely difficult to effect policies here that will even get it down that far. Everybody's tax ideas notwithstanding, everybody's good intentions notwithstanding, there is a huge amount of budget restraint that has to go into getting it there, and a lot of new taxes, so I would be thrilled if I saw a projection that said $100 billion by 1988, not because I like it, but because I don't see how we are going to get there by the time we have to redo the pension plans.

Nodoby has even talked about that. Both of them are in that budget. Civilian and military is left out. It has got to be fixed. Medicare has to be restrained about 6 percent a year for the next 3 or 4 years in growth, plus taxes. So I hope that isn't the case.

I appreciate your testimony and your written statements; which will be made part of the record.

Thank you very much.

Mr. FISCHER. Thank you, Senator.

Mr. FULLERTON. Thank you, Senator.

Mr. KAREKEN. Thank you.

[Whereupon, at 3:34 p.m., the committee adjourned, to reconvene subject to the call of the Chair.]

ECONOMICS

THURSDAY, FEBRUARY 17, 1983

U.S. Senate,
Committee on the Budget,
Washington, D.C.

The committee met, pursuant to notice, at 10:13 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Boschwitz, Grassley, Quayle, Gorton, Chiles, Biden, Johnston, Riegle, and Exon.

Staff present: Stephen Bell, staff director; Gail Fosler, chief economist; Richard N. Brandon, minority staff director; and Kemble Stokes, chief economist for the minority.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman Domenici. The hearing will please come to order.

Dr. Feldstein, let me welcome you on behalf of my colleagues to the committee. Personally, I want to do more than that. I want to compliment you for the job you are doing in these very difficult transition times, for the professionalism that you bring to the job and for the advice that you have given the President which has, for the first time in three budgets, at the minimum brought forth an almost unanimous sense that the budget is very realistic, that its economic outlook and projections are realistic.

In fact, it is rather gratifying to find that if there is criticism, it is on the side of being too pessimistic rather than too optimistic.

With that, I have some opening remarks. I am going to make them a part of the record, but I would suggest that I note a growing concern on the part of members of this committee, from what I can tell on both sides, about the issue of the Federal Government and job creating programs and expenditures or money for jobs. It is not because there is any unanimous feeling as to how we should do it or how much we should spend. Generally, at this point when the economy is recovering, everybody seems to be involved in a new jobs programs and is thinking of it.

I hope you can shed some light as to what is in the proposed jobs package and give us your views on just how much we ought to be spending in the area of jobs. The Federal Government is directly involved in the creation of jobs by the expenditure of funds that are directed in that respect.

Then, I would like very much that you discuss the economic outlook with us. I note that many indicators are already ahead of what many predicted, and I would like to know whether you think your economic outlook is any different now than it was when you were putting the budget together.

Eventually, I would like to ask you about your thoughts on Chairman Volcker's testimony regarding money supply and what advice you are giving the administration with reference to that.

I welcome you here, and I sincerely compliment you on your work.

PREPARED STATEMENT OF CHAIRMAN DOMENICI

Dr. Feldstein, on behalf of my colleagues, I welcome you to the Budget Committee. This is your first appearance as Chairman of the President's Council of Economic Advisers, although you have appeared before this Committee many times in the past as a private economist. As you know, the Council's Annual Report is a very important document because it should represent the depth and the breadth of the economic profession's views on public policy issues.

UNEMPLOYMENT

Let me discuss with you this morning two issues that are very much on my mind. First is an issue of direct concern to this Committee, the Administration's policies for the unemployed. We are well aware of the extensive negotiations now underway with the House. I hope you will discuss these negotiations in detail and the budget limits that you think we should set on this type of aid to the unemployed.

The question of limits is very important, Dr. Feldstein. Whatever we do in this area will reach only very few people. There are 11.4 million people out of work in this Nation. If we were to adopt a $5 billion public works program, we could create about 110,000 jobs which would help less than one percent of the total unemployed.

Let me be clear, Dr. Feldstein, I believe that the government has an important role in helping to reduce the burden of unemployment. But, as your report states very clearly, the approaches that we have used in the past are not effective. And, frankly, I am concerned that, given the size of the problem, we can endanger our longer term budget goals if we are not prudent. Therefore, I hope that you will provide this Committee with some clear guidelines as to the best way to structure a "jobs" effort and the funding limits that we should set on such a program.

ECONOMIC OUTLOOK

I also hope that you will address the issue of the economic outlook in your testimony, this morning. I understand that, in your testimony before the Joint Economic Committee two weeks ago, you indicated that you had become somewhat more optimistic about the strength of the recovery than you were at the time you developed the economic assumptions in the President's budget. Certainly, recent data would suggest a case for optimism. The significant improvement in the January unemployment rate was followed yesterday by a sharp increase in industrial production—across the board. And housing starts in January were 1.7 million units, which is the highest level since September 1979. Although I think that most economists expected a recovery this quarter, the strength of the snapback has come as a surprise. I hope you will discuss with the Committee if, in fact, you have changed your mind about the recovery. Is it possible, Dr. Feldstein, after so many months of gloom that we have occasion to be optimistic, especially if we get the long-term deficits under control.

Once again, Dr. Feldstein, it is a pleasure to welcome you and I look forward to your testimony.

Chairman **DOMENICI**. Senator Chiles?

OPENING STATEMENT OF SENATOR CHILES

Senator **CHILES**. Mr. Chairman, I join with you in welcoming our distinguished guest, and I think, Doctor, that the work that you have done is realistic and I think that your becoming the Chairman of the Council of Economic Advisers has certainly added some realism to the budget we have.

Mr. Chairman, I will submit my statement in full for the record. I will say that I am tremendously concerned and I think part of this is perhaps even expressed in your statement, Doctor, about what these deficits will do and whether we will see, as we get a recovery trying to come underway, whether there is going to be some crowding out.

We are how seeing that the president of the Mortgage Bankers has now indicated that he sees a great fear as to whether there is going to be sufficient moneys to fuel the kind of recovery we need. At the same time we see that the administration in its projected plan is not talking about doing anything on revenues until the year 1986.

That time delay concerns me as does the deficit that we are going to see added to by that delay. It seems to me that we have to do more on taxes than the President is suggesting, and my understanding is that you seem to feel that same way. A year ago you told the Senate Finance Committee it would at least be a good idea to stretch out the 10-percent tax cut scheduled for July 1983 and the 5-percent cut for July 1984 and July 1985, and that, of course, was with even lower deficit projections than we now have.

STRETCHING OUT THE TAX CUTS

That, to me, would be a good place to start. I am sorry that you appear to have changed your mind. During that same testimony you said something else that has come back to haunt us and it was the simple enough remark about the effects of stretching out the tax cut.

You said that stretching out the tax cut would achieve the same ultimate tax rates. The problem then is the same as our problem now—ultimate tax rates—and it is going to remain our problem in the future. That seems to me really to be the key.

All of the folks at the White House keep preaching that the value of the third year of the tax cut is a stimulus, but I think you saw it more clearly than that when you were at Harvard, and my guess is that you see it just as clearly now on the President's Council of Economic Advisers that ultimate tax rates will be 25 percent lower by the end of the year than they were at the beginning of 1981. Those are the rates that are going to push us into the kind of permanent deficit that we will not be able to erase with spending cuts alone.

I am not going to sit here and argue that big spending did not help get us into the trouble. Of course, it did, but we are not going to get out of it with big tax cuts. With the shape the economy is in, I strongly doubt that you would be here supporting a further tax cut this year if it was not already scheduled by law.

The economy is still in sad shape, and the administration is not only insisting on a short-term stimulus but also and without fanfare, has virtually guaranteed revenue shortfalls for years down the road.

CORRECT STRUCTURAL DEFICITS

I am familiar with the administration's plan to cut taxes dramatically, and then spending cuts will have to follow. That was the theory, but how far do you want it to go? Can it go through the bottom of the safety net? And it seems like even the administration recognizes that that can happen by virtue of the budget that they have now presented to us.

The administration does not seem to want to give up on the defense buildup. If we do not do that, then we find ourselves in a situation where we are facing a structural deficit.

Tax rates have already been cut by 15 percent, and I do not hear many taxpayers saying how much they appreciate the relief now. I frankly doubt that they will notice it much if the third year goes through in July, but they are going to notice it eventually because in the years ahead it is going to be seen as a case of pay-me-now or pay-me-later. Without the resources to lower those Federal deficits and reduce Federal borrowing, then the risk of those soaring interest rates is always going to be with us.

That is the threat that I think we really need to worry about. And I hope that as we go forward with this process, we can do something to correct those structural deficits.

PREPARED STATEMENT
OF
SENATOR LAWTON CHILES
RANKING MEMBER
SENATE BUDGET COMMITTEE

DR. MARTIN FELDSTEIN
HEARING
FIRST CONCURRENT BUDGET RESOLUTION
FY 1984

FEBRUARY 17, 1983

It's a pleasure to welcome you, Dr. Feldstein.

We seem to be on a "fast track" this year in the Budget Committee, trying for Senate approval of a First Concurrent Budget Resolution before the Easter recess. It's hard to know if we'll be able to do that. But, frankly, it's a little hard to understand why your budget projections aren't on a little faster track.

Your forecasts assume we will still have a relatively high unemployment rate until 1988. The budget predicts a budget deficit still at 117 billion dollars in 1988. That's quite a way down the road, and a long time to ask people to put up with economic hardship. I think we could be doing more than we are, and doing it faster than we are.

You will recall Congress acting last year to contain deficits. If we hadn't things would be even worse than they are now. We are willing to cooperate again, because if interest rates are going to come down and stay down, the deficit must be reduced.

During the last several months of 1982, we began to see interest rates come down. The White House was publically delighted. Privately, I think they were relieved. The President's economic program needed a little something to distract the public from the fact that the policy wasn't working. They got that "little something" from the Federal Reserve's easing of monetary policy. Interest rates started coming down. We heard better news from the housing and auto industries.

But interest rates in the past few weeks have started to inch back up as the size of the deficits predicted in your budget began to sink in. Just a week ago, the President of the Mortgage Banker's Association said he feared the deficits projected for 1984 through 1986, ". . . will continue to absorb increasing amounts of credit that the private sector sorely needs to ensure economic recovery".

I think he's right to worry because it's not clear now what path the Federal Reserve will follow in the months ahead. It looks like they are easing up, but Chairman Volcker is hedging his bets somewhat. He is still talking about restraint against the possibility of renewed inflation. My personal hope is that the Federal Reserve will go with the kind of prudent flexibility needed to keep interest rates from going back up through the roof. But the Federal Reserve can't do all that's needed with monetary policy alone. We -- the White House and Congress -- must do our part. I'm afraid the White House just isn't doing enough.

It's clear to me that we've got to do more on taxes than the President has suggested. It was just a year ago, Dr. Feldstein, that you seemed to feel the same way. You told the Senate Finance Committee last year it would at least be a good idea, "to stretch out the 10 percent tax cut scheduled for July 1983 into 5 percent cuts in July 1984 and July 1985". And that was with even lower deficit projections. That would be a good place to start, and I'm sorry you appear to have changed your mind.

During that same testimony you said something else that's come back to haunt us. It was a simple enough remark about the effect of stretching out the tax cut. You said: "That [stretching out the tax cut] would achieve the same ultimate tax rates . . ."

The problem then is our problem now, and will remain our problem in the years ahead; "ultimate tax rates". That's really the key. All the folks at the White House keep preaching the value of the third year of the tax cut as a stimulus. You saw it more clearly than that when you were at Harvard, and my guess is you see it just as clearly on the President's Council of Economic Advisers. "Ultimate tax rates" -- those rates that will be 25 percent lower by the end of the year than they were at the beginning of 1981. Those are the rates that will push us into the kind of permanent deficit we won't be able to shake with spending cuts alone.

Now I'm not going to sit here and argue that big spending didn't help get us into trouble. Of course it did. But we aren't going to get out of it with big tax cuts. With the shape the economy's in, I strongly doubt that you would be here supporting a further tax cut this year if it weren't already scheduled by law. But the economy is still in sad shape while the Administration is not only insisting on short term stimulus, but also -- without fanfare -- virtually guaranteeing revenue shortfalls for years down the road.

Of course I'm familiar with the Administration's plan: cut taxes dramatically and spending will have to follow. But how far do you

WANT IT TO GO? DO YOU WANT IT TO GO THROUGH THE BOTTOM OF THE SAFETY NET? THAT'S THE DIRECTION IT WILL HAVE TO GO TO KEEP PACE WITH THE REVENUE CUTS THE ADMINISTRATION PRESCRIBES. IT WILL HAVE TO PUNCH A HOLE IN THAT NET BIG ENOUGH TO SWALLOW MEDICARE, AND NUTRITION PROGRAMS, OR PERHAPS HOUSING OR VETERANS BENEFITS PROGRAMS.

OR YOU WOULD HAVE TO GIVE UP THE DEFENSE BUILDUP WE ALL WANT. DOMESTIC SPENDING FOR PROGRAMS LIKE THESE HAS BEEN MADE FLAT AS A PERCENTAGE OF GROSS NATIONAL PRODUCT. BUT REVENUES HAVE DECLINED SUBSTANTIALLY AND DEFENSE SPENDING CONTINUES TO GROW AT AN UNRESTRAINED RATE. THERE'S A TERM FOR WHAT THAT KIND OF POLICY WILL GIVE YOU. IT'S CALLED "STRUCTURAL DEFICIT".

IT SEEMS TO ME THE PRESIDENT HAS GOT TO REALIZE PEOPLE LIKE ME AREN'T TRYING TO PROD HIM INTO A TAX INCREASE. BUT I TELL YOU VERY HONESTLY I AM TRYING TO NUDGE HIM AWAY FROM FURTHER TAX CUTS. IN FACT, I HOPE WE WILL BE ABLE TO TALK HIM OUT OF IT ALTOGETHER.

TAX RATES HAVE ALREADY BEEN CUT BY 15 PERCENT. I DON'T HEAR MANY TAXPAYERS SAYING HOW MUCH THEY APPRECIATE THE RELIEF. I FRANKLY DOUBT THEY WILL NOTICE IT MUCH IF THE THIRD YEAR OF THE CUT GOES THROUGH IN JULY. BUT THEY WILL NOTICE IT EVENTUALLLY, BECAUSE IN THE YEARS AHEAD IT WILL COME TO BE SEEN AS A CASE OF "PAY ME NOW OR PAY ME LATER". WITHOUT THE RESOURCES TO LOWER THE FEDERAL DEFICITS AND REDUCE FEDERAL BORROWING, THE RISK OF SOARING INTEREST RATES WILL ALWAYS BE WITH US. THE THREAT OF A FRAIL ECONOMY WILL NOT GO AWAY.

WE CAN'T CONTINUE "CREDIT-CARD TAX CUTS" BECAUSE WHILE WE BASK IN THE SUNSHINE OF TAX RELIEF TODAY, EVERYONE WILL FEEL THE BURN TOMORROW. THE TAX CUTS WILL EXACT THEIR PRICE IN THE FORM OF MORE FEDERAL BORROWING, RESULTING IN HIGH DEFICITS AND HIGH INTEREST RATES.

WE SIMPLY MUST DO MORE TO FIGHT THE DEFICIT. DEFENSE SPENDING MUST GROW, BUT AT A MORE RESTRAINED RATE. DOMESTIC SPENDING WILL NEED TO BE CAREFULLY MONITORED, CUT WHERE NECESSARY, AND CONTAINED OVER THE LONG RUN. AND, OVER BOTH THE SHORT TERM AND THE LONG HAUL, WE MUST COME UP WITH A MORE REALISTIC REVENUE POLICY.

I LOOK FORWARD TO ANY SUGGESTIONS YOU MIGHT HAVE ON HOW WE CAN PROCEED.

Chairman DOMENICI. Dr. Feldstein?

STATEMENT OF MARTIN FELDSTEIN, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Dr. FELDSTEIN. Thank you very much, Mr. Chairman. Thank you, Senator Chiles. You have posed quite a number of questions on jobs, on the outlook, on money supply, on tax policy. If I get to answer all those this morning, I will certainly have earned my pay for this session.

I would like first to read my statement, and then I would be happy to try to answer those questions in whatever way you would like. I am delighted to come again before this committee.

Although this is my first testimony here as Chairman of the Council of Ecomomic Advisers, it is the third February in a row that I have had the opportunity to appear before you. Problems of the budget and the responsibilities of this committee have never been greater.

PRESIDENT'S BUDGET PROPOSAL WOULD SHRINK DEFICIT

As you know, the budget deficit this year will be about 6.5 percent of GNP. That figure as such is neither very surprising nor very disturbing for an economy that is just coming out of a very deep recession. More than one-half of the deficit is now due to the low level of economic activity.

What is very disturbing is that the budget deficits will remain at more than 6 percent of GNP until at least 1988 unless legislative action is taken to reduce those deficits. Although the cyclical component of the deficit will shrink in future years, the structural component of the deficit would grow just as fast. The result would be a 1988 deficit of $300 billion or 6.1 percent of GNP even though unemployment in that fiscal year is forecast to average only 6.8 percent.

The persistence of such deficits is intolerable and would do substantial damage to the economy in the years ahead. Fortunately, such extreme deficits can be eliminated. President Reagan has proposed a budget that would shrink the deficit to 2.4 percent of GNP in 1988.

This morning I want to consider first the adverse consequences that would result from a failure to achieve such substantial reductions in the budget deficit. I then want to discuss the basic reasons why the structural deficit has become so large. Finally, I want to comment on the administration's program to reduce future deficits.

Then, as I said, I would be delighted to try to talk about the other subjects that both of you raised.

First, why do we need to reduce the deficit?

POTENTIAL CROWDING OUT OF PRIVATE INVESTMENT ENORMOUS

A succession of large budget deficits would reduce substantially the rate of capital formation. The Government's borrowing to finance such deficits would compete directly with borrowing by private businesses and households. With a limited amount of savings available, high budget deficits would cause interest rates to rise until the private demand for funds was reduced to the amount that remained after the Government's borrowing needs were satisfied.

The magnitude of the potential crowding out of private investment is just enormous. During the past two decades, the net savings of households and businesses totaled only about 7 percent of GNP. Prospective deficits of more than 6 percent of GNP would represent virtually all of current net savings. Even though existing saving would probably be augmented by borrowing from abroad and by some increase in the private saving rate, the reduction in the rate of capital formation would certainly be very substantial.

A lower rate of capital formation would have very adverse consequences because the accumulation of capital is a key determinant of future increases in productivity and economic growth and therefore of higher real wages and standards of living. Deficits of the level implied by the current services budget could reduce the rate of net investment in plant and equipment enough to preclude any increase in capital per worker. If this occurred, the process of increasing capital intensity would cease to contribute to rising productivity and real wages.

BUDGET DEFICITS NOT LIMITED TO DISTANT FUTURE

The adverse effects of large budget deficits are not limited to the distant future. The deficits that would occur without legislative action would prevent a broad-based and healthy recovery. The crowding out of private investment would depress the level of output in the capital formation industries: construction, machine tools, steel, and so forth. In addition, large budget deficits raise the exchange value of the dollar relative to foreign currencies by attracting foreign capital to the United States. The stronger dollar makes U.S. exports less competitive in the world economy and makes foreign imports more attractive to American customers. The sharp deterioration of the balance of merchandise trade—experts now anticipate a 1983 merchandise trade deficit of $75 billion, nearly twice the level of the trade deficit in 1982 and three times the 1981 trade deficit—that sharp deterioration indicates the seriousness of this problem for our industries that are engaged in international trade.

A lopsided recovery in which some sectors remain relatively depressed might prove more fragile than a broadly based recovery. To put it bluntly, it is not clear whether a recovery can be long sustained if such key industries as steel, construction, and chemicals remains severely depressed.

Moreover, the likelihood of large budget deficits in the second half of the 1980's may also have a more general adverse effect on the prospects for recovery in 1983. If the financial markets respond to expected future deficits by keeping real long-term interest rates higher in 1983 than they would otherwise be, the level of spending in 1983 on interest-sensitive purchases may remain depressed.

In short, for a healthy and balanced recovery and a sustained expansion with increases in capital intensity and productivity, it is critical to make substantial progress in reducing the projected deficits. It is critical also that the outyear deficit reductions be legislated unambiguously at this time. Vague promises that subsequent legislative actions will reduce the deficit will be worth little or nothing in convincing financial markets. The administration's budget and the legislation to be submitted provide just such a program of deficit reducing legislative changes.

MISCONCEPTION OF WHY DEFICIT IS SO LARGE

Much of the debate about alternative ways to reduce the deficit starts with a misconception of why the deficit is so large. To be specific, I will focus on the 1988 current services budget deficit of $300 billion or 6.1 percent of GNP. Table 1 provides some useful summary figures for my purpose. Note that there are in this table two columns, the final two columns that are both marked 1988. The first shows figures for the current services budget and the second shows the corresponding figures for the administration's proposed budget.

TABLE 1.—FEDERAL GOVERNMENT BUDGET AS PERCENTAGE OF GNP

	1960 actual	1970 actual	1980 actual	1988 current services	1988 administrative budget
Line:					
1—Total outlays	18.5	20.2	22.4	25.1	23.0
2—Defense	9.1	8.2	5.3	8.1	7.9
3—Interest	1.4	1.4	2.1	3.4	2.7
4—Nondefense	8.0	10.6	15.1	13.6	12.4
Noninterest:					
5—OASDI	2.2	3.1	4.5	5.0	4.8
6—Medicare	0.0	0.7	1.4	2.2	2.1
7—Other	5.8	6.8	9.1	8.4	5.5
8—Receipts	18.6	19.9	20.1	18.9	20.6
9—Deficit	(0.1)	0.3	2.3	6.1	2.4

For comparison with 1988, the table provides information on the budget for fiscal years 1960, 1970, and 1980. The budget showed a small surplus in 1960. You can see the deficit on line 9 in parentheses (0.1) and a surplus equal to one-tenth of 1 percent of GNP in that year. And in 1970 the deficit was only 0.3 percent of GNP.

One of the most frequently heard myths is that the 1988 deficit is so large because taxes have been reduced so much. In reality, the share of taxes and GNP would be slightly higher in 1988 under even the current services budget—18.9 percent of GNP, line 8 in that next to the last column—than they had been in 1960 when they were 18.6 and only slightly lower than they had been in 1970 when they were 19.9 percent of GNP.

The second popular myth, that the 1988 deficit is so large because defense spending will be so high. In fact, the 8.1 percent of GNP provided for defense in the current services budget is lower than the defense share in 1970 when it was 8.2 percent and in 1960 when it was 9.1 percent of GNP.

GROWTH OF NONDEFENSE SPENDING FUNDAMENTAL CAUSE OF DEFICIT

The table shows very clearly that the fundamental cause of the deficit has been the growth of nondefense spending. Nondefense outlays, excluding interest, rose from 8 percent of GNP in 1960 to

10.6 percent in 1970 and 15.1 percent in 1980. In 1988, at current services levels, they would still be 13.6 percent of GNP.

Moreover the growth of nondefense spending has caused the accumulating deficits that have swelled the Government's annual interest bill. When interest costs are added to nondefense program outlays, spending nearly doubles from 9.4 percent—the sum of interest at 1.4 and other nondefense at 8.0—from 9.4 percent in 1960 to 17.2 percent in 1980. Returning the total of nondefense spending including interest to the 1970 level—hardly back to the Dark Ages in terms of social programs—would virtually eliminate the entire 1988 current services deficit of 6.1 percent of GNP.

Let me hasten to add that I do not underestimate the difficulty of reducing nondefense spending. I have spent too many hours in the budget process in the administration this fall to make that mistake. Reducing individual types of outlays is often either undesirable for economic or humanitarian reasons or is politically impossible because of the strong support of specific interest groups.

Chairman DOMENICI. Doctor, let me ask you now. That 17.2 which was nondefense plus interest, is that 1980 or 1970?

Dr. FELDSTEIN. 17.2 is 1980. It is the sum of the 2.1 and the 15.1. And in 1970 that number would only have been 12. So it rose from 12 percent to 17.2 percent as a percentage of GNP, an almost 50 percent increase in that decade.

Although Government spending has grown over a vast array of different types of programs, the bulk of the increase has been concentrated in the middle class entitlement programs that finance retirement, disability, and health benefits. As table 1, line 5 shows, the growth of outlays for the social security OASDI programs has risen from 2.2 percent of GNP in 1960 to 3.1 in 1970, 4.5 in 1980 and a projected 5.0 percent of GNP in 1988 on the current services budget.

Chairman DOMENICI. But that does not contemplate the Blue Ribbon Commission?

Dr. FELDSTEIN. The Blue Ribbon Commission's recommendations are included in the administrative budget in the next column. As you can see, the changes proposed by the Blue Ribbon Commission would take it down from 5 to 4.8, still substantially higher than it was in 1980 and more than double what it was as a percentage of GNP back in 1960.

The medicare programs which did not even exist in 1960 accounted for 0.7 percent of GNP by 1970 and represent outlays of 2.2 percent of GNP in the 1988 current services budget. Thus OASDI and medicare alone have risen from 2.2 percent of GNP in 1960 to 3.8 percent in 1970 and a projected 7.2 percent in the 1988 current services budget. The administration's budget begins the important task of making structural reforms in these programs, reforms that could, over time, reduce their share in GNP.

STRUCTURAL REFORMS NOT QUICK ENOUGH

Although such structural reforms are critically important for the long run, they cannot reduce outlays quickly enough to get the deficit to an acceptable level by the end of the current 5-year budget horizon. The administration's budget does reduce the projected 1988 deficit from the 6.1 percent rate implied by the current services budget to 2.4 percent of GNP.

A comparison of the last two columns of table 1 shows how this proposed deficit reduction is to be achieved. Receipts rise from 18.9 percent, shown in line 8, under the current services budget, to 20.6 percent of GNP, an increase of 1.7 percent of GNP.

Senator CHILES. Excuse me for interrupting you. Your 1988 current services budget, does that include administration figures or CBO's current services figures?

Dr. FELDSTEIN. That is administration figures.

Senator CHILES. You do not have a column for CBO's current services figures?

Dr. FELDSTEIN. No; I do not. I have looked at the CBO figures, although not in great detail. My impression is that the differences between CBO and the administration are really quite small this year.

Senator CHILES. How about in defense?

Dr. FELDSTEIN. Let me define current services so we are clear about what I mean. By current services I mean current services, including the administration's previously announced defense program.

Senator CHILES. But it is not current services from where we started last year and what we passed last year.

Dr. FELDSTEIN. On the defense side it is not. On the defense side it includes the expected future budget.

Senator CHILES. But you have monkeyed with defense numbers just like——

Dr. FELDSTEIN. I did not mean to be monkeying. I just meant to be—it is a shorthand, and I have probably fallen into that over the months calling it current services rather than base line or current services plus needed national defense spending, which is the long label that we have given it in the past. Excuse me for being unclear about that.

Chairman DOMENICI. That would be easy for us to figure out. I think the concern would be what they would estimate the defense number to be if they used the same definition of current services. I think that would be relevant and we could get an answer to that.

Dr. FELDSTEIN. I could tell you roughly what that would be, but I would be nervous about giving it to you as a percentage of GNP on the spot.

Chairman DOMENICI. We can dig that up.

RECEIPTS WOULD GO UP UNDER ADMINISTRATION'S PROPOSAL

Dr. FELDSTEIN. I was just pointing out before Senator Chiles raised that question, what has happened to receipts under the administration's proposal. Receipts would actually go up between current services, current law, and the administration's budget from 18.9 percent of GNP to 20.6 percent, an increase of 1.7 percent of GNP. Outlays are reduced from 25.1 percent to 23 percent, a decline of 2.1 percent of GNP. Those numbers are roughly speaking equal, and I will comment on that in some more detail in a minute.

The spending reductions include 0.2 of a percent of GNP for defense, 0.3 of a percent for the OASDI and medicare programs and

0.9 of a percent of GNP for all other nondefense spending. The smaller deficits in each year imply a smaller Government debt in 1988 and therefore interest savings of 0.7 of a percent of GNP.

These interest savings which are larger than the combined changes in OASDI, medicare, and defense, are nearly as large as all the other nondefense changes. This 0.7 of a percent shows just how important it is to start quickly to reduce the budget deficit.

GROWTH OF SPENDING PRIMARY REASON FOR PROJECTED DEFICIT

Some critics of the administration's program have argued that too much of the deficit reduction is to be achieved by spending cuts and not enough of it by revenue increases. As I noted a few moments ago, such an argument ignores the fact that the growth of spending has been the primary reason for the projected deficit. Moreover, most of the deficit reduction excluding interest savings in 1988 actually comes from increased revenue which is up 1.7 percent of GNP rather than from decreased outlays which are down 1.4 percent of GNP. In looking at the 5 years from 1984 through 1988 as a whole, it shows a roughly equal mix of outlay reductions and revenue increases. Outlays excluding interest, decline a cumulative total of $249 billion, while receipts increase by $234 billion.

Chairman DOMENICI. Doctor, do you have a number that breaks the 1.7 increase in receipts which is taxes collected, into how much of that increase is from growth in economy and how much is new taxes?

Dr. FELDSTEIN. No, that is not growth in the economy at all. This is a comparison of 1988 under two different budget proposals. So it is the same economics in 1988. The next to the last column, the 18.9 is on the current services assumption, current law assumption. The last column is the administration's budget. So that is all net legislated increase in taxes, over and above the increase in taxes that would occur between now and 1988 as a result of the economic recovery.

Chairman DOMENICI. So we assume the same economics.

Dr. FELDSTEIN. The same economics in these last two columns?

Chairman DOMENICI. Correct.

Dr. FELDSTEIN. Two different sets of laws. The law change for 1988 would be 1.7 percent of GNP and that is roughly speaking about $85 billion in 1988 alone in new taxes, additional taxes.

Just in conclusion, I would summarize that the budget deficit problem is of critical importance to the economy. Enacting legislation that will reduce the level of deficits in the second half of this decade is a prerequisite of a healthy recovery and a sustained long-term economic growth. The administration's budget proposes a clear, and I think, workable way of reducing the future deficits by a balanced combination of spending reductions and revenue increases. It is now up to this committee and to the Congress to take the next steps toward assuring a sound and sustainable recovery.

Chairman DOMENICI. Thank you very much, Doctor.

Would you let me go back with you now to the economic outlook? The recent data indicate that there is some real strength in the economy. Have you changed your outlook? Do you think that we may get an economic recovery that is stronger than that which you assumed in the budget? Could it be stronger than CBO's forecast?

RECOVERY MORE LIKELY THAN BEFORE

Dr. FELDSTEIN. Well, in the budget and in our forecast, we said a 3.1 percent increase between the fourth quarter gross national product 1982 and the real fourth quarter GNP this year, and that, as I emphasized at the time, was a balancing of probabilities, a weighing of the question of just when the recovery would begin and how strong it would be when it began.

Certainly in the 6 weeks since we completed our budget and the President signed off on that budget, there have been more and more signs that a recovery is, indeed, either here or about to begin.

The good employment news that we had the other day is certainly encouraging. The dramatic increase in housing reported yesterday is encouraging. Favorable news on industrial production is encouraging.

Indeed, what has happened in the last month is that instead of having just a string of leading indicators which we had had for about 8 months, we have finally begun to have some statistical measures that indicate an increase in current, rather than just future economic activity. So, I think it is not surprising that most economists are now concluding that a recovery is more likely than before.

I think if I were redoing the forecast today, I would increase the estimate for growth this year, but still by a rather moderate amount, by a few tenths of a percent, not by enough to warrant going back and redoing the numbers, because I do not believe that any of the decisions that this committee or the Congress will take, would or ought to be different if the forecasts were for a few tenths of a percent higher growth in this year.

EMPLOYMENT FIGURES HAVE QUESTION MARKS

I think there are still a number of uncertainties that have to be borne in mind despite the good news. The figures on employment, which I regard as the most encouraging sign that we have had to date, have some question marks associated with them.

The household survey that produced the 10.4 percent unemployment rate, instead of 10.8 in the month before, had the anomalous aspect that employment actually did not increase, that it was a decrease in unemployment wholly reflected by a reduction in labor force participation.

That is just not the way recoveries normally begin in a statistical sense, and there is the worry that that reduction in unemployment and the unemployment rate is exaggerated by seasonal correction factors.

More encouraging, I think, was the employment news, the fact that the establishment survey, the survey of businesses which came out at the same time, showed a 340,000-job increase in the number of people working. But even there I would urge a little bit of caution because virtually all of the increase was in retailing and in construction, and those, again, are two industries very much affected by the seasonal adjustment process at this time of year. A little bit of good weather or an unusual pattern of hiring and layoff of Christmas workers would affect construction and retail sales in a way that I think still requires some caution.

So I want to watch very carefully to see what happens to the unemployment insurance numbers during this month and what happens to the new unemployment and establishment employment surveys that will be released the beginning of next month.

TWO UNCERTAINTIES CONTINUE TO CLOUD RECOVERY

There are two other uncertainties that I think continue to cloud this recovery. One of them is what is happening in financial markets. Real interest rates are very, very high. They are much higher than they have been at this point in previous recoveries. They are much higher than they were the last time that inflation was at the current level, and that is bound to put a damper on all kinds of interest-sensitive activities.

Related to that, but I would emphasize it as a second point, is the international economic situation that I referred to in my testimony. A $75 billion trade deficit is just something completely new for our economy, three times as big as 2 years ago.

That means a substantial amount of potential final demand in this country that will actually be felt in Europe and Asia rather than in American markets, and that also, I think, will dampen the speed of the recovery.

So that while about 5 percent has been the typical rate of growth of real GNP in the first 12 months of economy recoveries in the last quarter century, I think we are facing an unusual situation which would make me reluctant to forecast that we would have that fast an economic recovery at the current time.

I have, nevertheless, said in the past that it is not out of the question. I used the words, "I would not be surprised if we had as much as 5 percent," but I would not want to make that as an economic forecast.

ADMINISTRATION WOULD LIKE INTEREST RATES DOWN

Chairman **Domenici**. Yesterday, Chairman Volcker indicated from what we can tell in his testimony before the Banking Committee that the Fed does not intend to continue to lower interest rates.

I personally find that very disturbing. Interest rates have, indeed, risen slightly over the past few weeks. I think they are already, even at this level, too high for real economic recovery. Does the administration support holding the line on interest rates now or would the administration support a more growth-oriented policy on the part of the Fed in terms of bringing them down?

Dr. **Feldstein**. I want to be very careful in the way I answer the question so as not to give any misleading impression.

Chairman **Domenici**. I understand.

Dr. **Feldstein**. I think the administration has been very pleased with the job that the Fed has been doing, and the President has said publicly that he thinks that the Fed is on basically the right track.

I certainly feel that the Fed is doing a good job, and I think that their decisions about how to handle the very complex situation that they are in now as a result of changing financial regulations is very commendable.

We would all like to see interest rates get down. I do not think that the Fed can bring down and hold down interest rates by a change in monetary policy at this point. I think that easing of monetary policy, increases in money growth rates, could have just the opposite effect on critical long-term interest rates.

I think financial markets are very nervous about inflation in the outyears. The primary cause of that nervousness is the budget deficit. People fear, and it is not just here but in Europe as well, that these budget deficits will lead to inflation because they will be pressured to try to force down interest rates by monetary means even though those interest rates are high primarily because of real factors. So what we are seeing now is interest rates that are abnormally high because there is a prospect still of very large budget deficits, then superimposed on that the fear that those deficits will lead to an inflationary monetary policy.

I think that the best thing that the Fed can do is to continue to reassure financial markets that they are not going to give up the fight on inflation and try to bring down interest rates, because that has been tried in the past and has failed.

I think there is no question the administration would like to see interest rates down. But I think the President summarized it very well in the state of the Union message when he said, "Another 2-percent decrease in the interest rate would be a very welcome stimulus to this economic recovery, but the only way to have that happen is to remove the fear of increased inflation in the future."

NO BACKING AWAY FROM ANTI-INFLATIONARY POLICY

Chairman DOMENICI. There seems to be a lot of fear around that those last M numbers show too much loosening. I personally think they are rather irrelevant at this point because I think too many other things happened.

The new accounts we permitted in the banks and lending institutions moved money around in such dramatic ways. Do you agree that that little tiny piece where there was such big growth evidenced in the M accounts is not an indication of that much loosening in money supply?

Dr. FELDSTEIN. I agree completely. I think that what we saw in January was a 2.5-percent increase in the stock of M_2 as money shifted from outside M_2 into the banks. But of course, when that gets restated as an annual rate, it comes out at 30 percent annual rate of increase.

But fortunately, and frankly I worried about this before it happened because I could see it coming, I was not sure how the financial markets were going to respond, whether the financial markets were going to be afraid that the Fed was pouring oil on the fire and trying so hard to stimulate a recovery that they were easing money too much.

But I think the financial markets understood what was happening. They understood that this was a shift of funds and that it did not indicate any backing away by the Fed from its anti-inflationary policy.

And we have seen evidence that that has been the financial markets' reaction from the fact that when those numbers were announced, there was no adverse affect on long-term interest rates.

Chairman DOMENICI. Senator Chiles?

FINANCIAL INVESTORS LOOK BEYOND 2 OR 3 YEARS

Senator CHILES. Well, you pointed out in your statement that during the past two decades the net savings of households and businesses totalled only about 7 percent of GNP. The tremendous danger is what is happening out there to the markets which are looking at these high deficits, and yet we see under the projected path that you are talking about an 1985 deficit of 5.1 percent of GNP and a 1986 of 3.6 which would eat up 73 percent of savings and 51 percent of savings.

Why are we waiting so long? The Secretary of Treasury said yesterday that a businessman only looks at 2 to 3 years and yet you are trying to focus people on 1988. If they only look at 2 to 3 years, is it not going to scare the pants off of them and is not that what is happening now?

Dr. FELDSTEIN. I think how far you look ahead depends upon the business you are in. The financial investors who are looking at long-term bonds, who are thinking about buying 20-year mortgages, obviously have to look beyond 2 or 3 years.

I think I would like to see these deficits come down more quickly, but I think that what we have is a balancing of different considerations which makes it difficult to bring the deficits down any more quickly than this.

Senator CHILES. Balancing of different considerations?

Dr. FELDSTEIN. Let me be more precise. If we had a substantial tax increase in 1983, we could get the deficit down more, but I think we could jeopardize the recovery much. I think that would be a mistake.

Senator CHILES. Well, I would agree if we had a substantial tax increase. But, if we did not have the third year passed into law, would you, as an economist, be recommending a permanent tax cut of $30 billion at the time we are facing $200 billion deficits, at the time that a recovery is underway?

Dr. FELDSTEIN. This would hardly be the first time in a recession that a tax cut had been recommended. But I think the point is we do have the tax cut in law.

Senator CHILES. I did not say it would be the first time. I am asking you if you with your experience would be recommending a permanent tax cut of $30 billion.

Dr. FELDSTEIN. That is really just too hypothetical a question. I will pass on that one.

[Laughter.]

"STRETCH OUT" TAX CUT

Dr. FELDSTEIN. But let me go back, if I may, to what you said in your introductory remarks about my comments before this committee last year. I did say at that time that I thought it would be a good thing to stretch out the third year of the tax cut into one-half in 1983 and one-half in 1984 or one-half in 1984 and one-half in 1985, I say "stretch out," not "eliminate," because I thought it was important to bring those tax rates down ultimately, to use your word.

But also I said those words before the TEFRA, before last year's tax bill was passed. So I want to be very clear that the reason that I judged last year that it would be appropriate to stretch out the tax cut and do not support that view now is that in the intervening months there has been a tax increase which, on a dollar amount, was as large as the entire third year of the tax cut.

Senator CHILES. But we also had deficits that were much smaller when you made that statement than the deficits we are looking at now.

Dr. FELDSTEIN. I cannot remember precisely what I said last year, but my recollection is I have been talking about 5-percent current services deficits for as long as I can remember talking about this subject. So I do not think that the deficits that we see now have come as a great surprise to me. I think they were in my thinking when I appeared before you previously.

Let me talk about the personal tax cut. You commented that people do not rush up to you and tell you how pleased they are. They have not taken much note of that 15-percent tax cut, and that is because to a large extent, it has been offset in the bracket creep that has occurred over this period.

There has been a small net tax cut in 1982. The first significant tax cut for individuals will really be in 1983. When the dust settles, if my calculations are correct, the share of taxes paid by a median income family will be very, very similar in 1988 under our current law, with indexing, to what it was back in 1981. In 1981, a median income family paid Federal income and social security taxes of 18.7 percent of income, and in 1988, under your existing law with the 5-, 10-, and 15-percent cuts and with indexing, under our forecasts, we would expect them to pay about 18 percent.

So the whole reduction as a percentage of income is from 18.7 to 18.

FORECAST CONSISTENT WITH ADMINISTRATION'S BUDGET

Senator CHILES. Well, given that you are even talking about the path where we show these deficits come down in 1988, and under the administration's figures you get down to around $117 billion—I think CBO has now estimated that you are around $160 something billion using the administration's numbers, what concern do you have as an economist that that deficit in 1988 at full employment, after 5 years of 4 percent real growth for 5 years in a row is all a structural deficit? Therefore, it is there and it is going to be with us. Is not that also non sequitur that you could not have inflation stay at the number you are really talking about or have unemployment come to where it would be if you were going to have a structural deficit and end up with interest rates being $50 billion higher in 1988 than they are in 1982?

Dr. Feldstein. No, I would say we could have the forecast. I think the forecast that we have made is consistent with the kinds of deficits implied by the administration's budget.

It would not be consistent with the current services deficit. We could not have 6 percent of GNP deficits. But if we get the deficits down to about 2 percent of GNP that is perfectly consistent with the kind of recovery, the kind of interest rates, the kind of inflation path that the administration has forecast.

Senator Chiles. What about the fact that it is structural, though, so that it is not going to get any better as such?

Dr. Feldstein. Well, let me be clear on what not getting any better means. It means there is no more cyclical recovery to shrink the deficit. It is true that if we stay on the same spending path and the economy continues to grow out beyond 1988, the share of the deficit in GNP can continue to shrink towards zero.

I would like to see a 1-percent of GNP deficit. I have no reason not to want a minus 1 percent. The Government could actually do some net savings and be contributing to the capital pool, retiring some of the national debt. That would be a plus.

I do not want to make too much out of the distinction between 2.4 and 1.0 or even 0.0 as a deficit. Smaller deficits are better than bigger deficits, no question about that.

Senator Chiles. Well, if we do not want to make too much out of that, are we making too little out of $50 billion additional interest which is certainly a crowding out of spending whether it be for defense or for nondefense programs?

Dr. Feldstein. I have a hard time trying to figure out where our conversation is going, because the administration's budget calls for about a $200 billion cut in the deficit in 1988 and substantial cuts in the deficit in each of the preceding years.

It calls for more taxes. It calls for less spending so I am not sure what it is that you are looking for.

MONETIZING THE INTEREST RATE

Senator Chiles. Well, I am just trying to find out. I mean it is your budget that you are coming up with. My concern is that the deficit is too high in 1988 and that it is too slow in coming down in 1985 and 1986. That is where I am coming from. You cannot really arrive at your projections that you have because inflation just will not come down, will not be that low if you have that kind of interest rate. You will have to be monetizing that interest rate.

Dr. Feldstein. No. There may be pressure on the Fed to do it. There may be political pressure on the Fed to try to brinq down the interest rate by expansionary monetary policy but if the Fed holds, if the Fed says, "No, we will not do that; we will accept slightly higher real interest rates," then real interest rates can stay a little higher than they have historically but come down substantially from where they are today.

We can see as confidence grows that there will not be increasing inflation. We can see market interest rates falling. There is no question that there will be higher real rates under large deficits than there would be under small deficits.

But if financial markets are confident that there is a program that is bringing those deficits down and that we will soon be down to the 1 to 2 percent range, then I think that the problem is not, in any sense, a severe one or one that will stop the economy from having the kind of recovery that we have forecasted.

Chairman DOMENICI. Senator Johnston?

Senator JOHNSTON. Thank you, Mr. Chairman.

THREE BIG DECISIONS TO BE MADE

Dr. Feldstein, it seems to me that there are three big decisions that we have to make on this committee. The first is whether or not to suspend the third year of the tax cut in whole or in part; the second deals with indexing; and the third with national defense.

It seems to me that these three areas are where the real cutting edge is. There are some other little things we are going to adjust, but basically, I think the Congress has made its decision on social security. Not all of us are enthusiastic about the decision, but I think that is pretty well saucered and gloved as we say, it is pretty well settled; and the other big decisions have been made.

Now, Chairman Volcker in testimony yesterday indicated to me that, at least my conclusion is, that he is much more worried about inflation than about aborting the recovery from monetary policy.

If he is correct, would that not also dictate that we should be worried more about inflation and therefore cut the third year of the tax cut?

Dr. FELDSTEIN. Well, my reading of Chairman Volcker's testimony is that he laid equal stress on both, that the monetary expansion that he wants to see in this year is to be consistent with both a sound recovery and also with stopping inflation from moving on, spiraling into higher levels. It is a balanced concern between the two.

Senator JOHNSTON. You are saying if we do not let that third year of the tax cut go in, it could hurt?

Dr. FELDSTEIN. No; I had not said anything until now about the third year of the tax cut. I was just commenting on what I understood to be the Fed's concern, and that it was not a one-sided concern with inflation and not with the recovery, but rather was a balanced concern with both the recovery and inflation.

As far as the tax cut goes, frankly, I do not see any significant link between the tax cut and inflation.

Senator JOHNSTON. Interest rates.

Dr. FELDSTEIN. Yes; but if you have a——

CONNECTION BETWEEN INTEREST RATES AND DEFICIT

Senator JOHNSTON. Your whole statement talks about the connection between interest rates and the deficit.

Dr. FELDSTEIN. Right, but let me explain. If we have a larger deficit, that in itself is not inflationary. That in itself will have other adverse effects. It will make for higher interest rates. Those higher interest rates will have a potential adverse effect on the recovery and on particular interest-sensitive industries.

But do not think about eliminating the tax cut in order to keep the inflation rate down. I think what you want to ask yourself is whether you can justify taking the risk to the recovery. I do not think you should take that risk. I think eliminating the third year of the tax cut at this point would be a significant undermining of potential consumer spending, and I think that would be a mistake.

Senator JOHNSTON. Higher interest rates do not produce higher inflation?

Dr. FELDSTEIN. Higher interest rates do not produce higher inflation. Higher interest rates may be the product of higher inflation and of higher inflation expectations about the future, but an increase in real interest rates would have the opposite effect, have the opposite effect because it would reduce aggregate economic activity, and if anything, that would reduce the rate of inflation.

RECESSION CAUSED BY HIGH INTEREST RATES

Senator JOHNSTON. Well, was not this recession really caused by high interest rates?

Dr. FELDSTEIN. I would say ultimately the recession was caused by the inflation that we had but I would say the more proximate cause was probably the higher interest rates.

Senator JOHNSTON. Right, and the reason those interest rates did not come down was because of the fear of deficits to a large extent in the outyears. The money managers who set the rates for long-term interest rates simply would not bring them down to historical levels on the real level.

Dr. FELDSTEIN. That is correct.

Senator JOHNSTON. And it seems to me the best way we can effect that is by getting those deficits down as soon as we can, by suspending the third year of the tax cut.

Dr. FELDSTEIN. No. If you brought down the deficit in 1983 but did not do things that would make it clear that the deficit was going to be lower in the outyears, then it would be counterproductive.

I think that if the Congress fails to make the kinds of spending changes that ultimately keep the deficit down in the long term, then I think that the fear of the deficit will stay there and interest rates will remain high.

Senator JOHNSTON. Well, what is the administration's alternative to the standby tax which I think everyone on both sides of the aisle concedes does not have any chance at all?

Dr. FELDSTEIN. The administration has no alternative to the standby tax. The administration has proposed the standby tax. I think it is a good idea. I think it is an intelligent way of responding to the fact that we cannot be sure about the future and that if we need a tax, we will have a tax, but if we do not need a tax, we will not have a tax.

Senator JOHNSTON. If you accept the view of all of us up here, I think all of us, at least most of us, have that it does not have a chance in the world, then should we not come up with some alternative like suspending indexing or the third year of the tax cut?

INDEXING THE MOST CRITICAL PROBLEM

Dr. **Feldstein**. Well, let me talk about indexing, because I think that really is the most critical problem that we will be faced with. I think that would be a terrible mistake from a variety of points of view.

I think if Congress voted to suspend indexing, the immediate reaction in financial markets would be an increase in interest rates, and let me explain why.

I know you would do it with just the opposite hope in mind. I know you would think about suspending indexing as a way of producing more revenue and bringing down interest rates. But as you know, suspending indexing does very little for revenue under the kind of inflation forecasts of the administration and the CBO.

With gradually declining inflation at quite low levels, there is very little impact on revenue of eliminating indexing, but if inflation takes off, then it is a tremendous revenue producer.

If I were a financial investor, I would be very worried that if indexing were not there, there would be all kinds of political pressures on the Fed to produce a more inflationary environment because it would solve so many problems. It would be such a generous source of revenue.

We did some calculations just to see what that would be, and I offer these as approximate numbers, not the kind of finely honed numbers that the Treasury can produce for you, but I think they are essentially correct.

In 1988, if we did not have indexing, then given our forecast of inflation, there would be about $35 billion of additional revenue in 1988. But if the inflation rate were 6.5 percent between now and then, it would be $70 billion. And if the inflation rate went back to the pattern that it had had during the 4 years of the Carter administration, rising higher and higher, it would be $115 billion.

I would be very afraid that eliminating indexing would be a signal that we were going back to inflation.

Chairman **Domenici**. Senator Exon?

Senator **Exon**. Thank you, Mr. Chairman.

ECONOMICS IS INEXACT SCIENCE

Dr. Feldstein, thank you for coming. We here on this committee have some important duties to discharge, and the fact that you come here this morning to give your and basically the administration's ideas are helpful to us. I guess that I should say, though, that generally perceived that economics is at best an inexact science and I assume that you agree with that.

Dr. **Feldstein**. Yes; I do.

Senator **Exon**. Certainly, I would say that your profession has a solid record of accomplishment to back up that conclusion as those of us who have sat here and listened to economists over the years, well-meaning as they are, things do not seem to work out.

I think above everything else we have to be realistic. I congratulate the administration for the budget that they have sent up here, the first realistic budget that I think that we have had to deal with by this administration.

Second, I think that while the sightseeing that you have done into the immediate future may be somewhat low, I think that also the projections that you obviously have had a hand in in this administration makes our job much easier from a realistic standpoint.

But talking about that and being realistic, are you going to recommend as the chief economic adviser to the President that he continue to advocate the balanced budget amendment? Are you going to recommend that he appear on the steps of the White House in a rally and push for a balanced budget amendment when it is obvious that even if he serves 8 years, his administration is not going to be able to balance the budget? Is that a realistic performance by the President?

PRESIDENT STILL BELIEVES IN BALANCED BUDGET

Dr. FELDSTEIN. Well, I will not comment on what I will actually recommend to the President privately. The President certainly still believes in the goal of moving toward a balanced budget and he has said that he regards the budget that he has submitted this year as not the last budget that he is going to submit and that if this budget is passed and we see in future years whether the economy is moving rapidly enough towards balance, he would make additional proposals that would move us more rapidly toward a balanced budget.

Senator EXON. Do you agree with my consensus that this is the first realistic budget that the Reagan administration has presented to the Congress?

Dr. FELDSTEIN. Well, I think that the forecasts in the past 2 years have, after the fact, turned out to have been incorrect, but I would add that that has been true of private forecasters at that time as well.

I think that private forecasters last year were generally expecting an upturn in the early part of 1982. Obviously, experienced showed that this was a much longer recession than anyone had counted on. So it is easy to be critical with hindsight. I hope that the future treats me a little more kindly than it did the previous sets of forecasts.

Senator EXON. Dr. Feldstein, I am not going to ask you what you would recommend to the President on the balanced budget amendment. What do you recommend as an economist to this committee and the Congress? Do you think we should push ahead on the balanced budget amendment?

BALANCED BUDGET AMENDMENT A POLITICAL DOCUMENT

Dr. FELDSTEIN. Well, what I have said before here in Congress is that I think the balanced budget amendment is not an economic document so much as it is a political document in the best sense of the word.

It is a reflection of a very broad feeling in the American public that budget deficits are a bad thing. Now, whether the particular form of the balanced budget amendment that is currently in Congress is the right way of capturing that and of achieving these widely shared aims is more a legal and a political question than it is an economic question. I do not feel that I am expert enough on that subject.

Senator **Exon**. Would you be comfortable, Dr. Feldstein, or would it compound your advisory role to the President today if the balanced budget amendment were in effect right now?

Dr. **Feldstein**. I do not think it would make the job more difficult, but frankly I have not thought about what I would be doing now if we did have that amendment on the books. So it is a bit of a hypothetical question for me.

Senator **Exon**. Thank you, Dr. Feldstein. Let us move to another subject. It was reported by rumor, probably it was not accurate, but before the 5-cent gas tax increase was endorsed by the President, it was reported, at least, that you had indicated that if we were to enact a 5-cent gas tax which we did during the lame duck session. that essentially it would be a wash as far as effecting unemployment was concerned.

In other words, we would be in a situation where we would have some new jobs with the construction but we would lose some. What do you have to say about that?

Dr. **Feldstein**. That is essentially correct. The President said that that should not be regarded as a jobs bill, but should be regarded as dealing with the problems of roads, highways, bridges, and mass transit, and that its impact on jobs was questionable.

Senator **Exon**. So that is still your belief. It is not a jobs bill. It is essentially a wash.

Dr. **Feldstein**. That is correct.

Senator **Exon**. Thank you. Let me go into one other matter here that I think is important to rural America particularly. Have you done any studies, or do you have any figures on the effect of the PIK program on rural America over and above the fact that we do hope it will be successful in reducing production? It seems to me the more I look at this program, it is going to have significant ramifications as it rumbles through our society as to what it is going to do to rural America from the standpoint of what is going to happen on Main Street. Have you done any figuring on that?

Dr. **Feldstein**. No. I have heard some of the same things that I think you may be referring to about the fact that reducing production in itself has some adverse effects on industries that supply agriculture, but I have not done any studies at CEA.

PRESIDENT'S JOB PROGRAM

Senator **Exon**. Dr. Feldstein, could you possibly spell out for us the jobs program that the President seemingly has endorsed and he made reference to it last night in his press conference?

Dr. **Feldstein**. Well, there are, as you know, two parts to the administration's jobs program. The main part that the President referred to in the state of the Union address deals with structural unemployment, with the extension of the Federal supplemental compensation, and that will be contained in legislation that will be coming up to Congress very soon.

That deals with young people. It deals with the Job Training Partnership Act. It deals with Federal supplemental compensation and other things.

More recently, there have been discussions between the administration and Members of Congress in both Houses and both parties about some short-term measures which will combine humanitarian spending, and more importantly in terms of the dollar amount, a moving forward in time from 1984 and 1985 of certain maintenance and construction activities that were already provided for in the budget. I think the President referred to both of those last night.

PIK'S EFFECT ON RURAL AMERICA

Senator EXON. Thank you very much. In closing, Dr. Feldstein, I would like to recommend if possible that you could put the people at your command to work on the matter of what PIK is going to do to rural America. It is going to have, obviously—I do not think it is worked into your figures—it is going to have an obvious impact, it seems to me, on the GNP. By meaning it is going to come down if we are going to produce less in agriculture, it is going to come down.

It could be that the PIK program might be a temporary shot in the arm for rural America that I assure you is in deep, deep financial trouble today, and I think that possibly we should be taking a look at that specific sector.

I have not seen the significant turnaround in Nebraska yet, that seems to be taking place in other areas of the country. I hope it comes, but I do think that the PIK program is going to have a very specific effect. And I am wondering how bad it is going to be.

Dr. FELDSTEIN. Well, we will look into that, Senator.

Senator EXON. Thank you.

Thank you, Mr. Chairman.

Chairman DOMENICI. Senator Grassley?

DON'T TURN ECONOMIC GROWTH INTO MORE SPENDING

Senator GRASSLEY. Thank you, Mr. Chairman and Dr. Feldstein. Is an increased economic growth rate that might be possible with an expanding economy next year looked upon by people within the administration as a way of being able to spend more money?

Dr. FELDSTEIN. I would say no.

Senator GRASSLEY. Well, I think up here on the Hill it might be. See, I think the feeling up here on the Hill is we can live with $110 billion deficits or $200 billion deficits so if we have another $10 billion coming in that we did not expect 2 months ago, then we will spend that $10 billion.

So I guess I am wondering what is the feeling downtown?

Dr. FELDSTEIN. I understand your question now. If, in fact, we have a stronger recovery than our budget forecasts——

Senator GRASSLEY. And the economic growth is more than 3.1 percent.

Dr. FELDSTEIN. That is right, and that produces more revenue, then we want to see the deficits be smaller. We certainly do not want to see that turned around into more spending.

Senator GRASSLEY. If that is established as this budget year goes on, in the next 3 or 4 months, we will not have a lessening effort on the part of the administration then to spend money. That additional income then, would mean lower budget deficits.

Dr. Feldstein. Absolutely.

Senator Grassley. OK. Well, you see what we are fighting here on the Hill, is the fact that there are those who want to reduce deficits and then there are some that want to increase taxes and do some cutting so that you reduce the deficits, and then there are some people who, if there is additional revenue coming in, just want to spend more.

I think what we have to do is focus upon, you know, every opportunity of getting those deficits down, and I would hope that any increase in the economic climate in the next few months will not depart us from our efforts, from that goal that we have of getting those deficits down.

Now, this is going to be a constant battle up here because every dollar they get, they want to spend more. So we need that sort of help.

More specifically, the President's budget shows a spending increase twice the rate of inflation, and nearly twice the rate of economic growth over the next 5 years. Is this good economic policy in your judgment as a professional economist? My personal view is that the President's budget does not restrain spending enough in the next 5 years.

OUTLAYS WILL GROW SLOWER THAN GNP

Dr. Feldstein. Senator, let me understand what you said. Somehow that does not seem to be right. Let me say what is right, and see if we actually disagree.

Outlays will grow more slowly between now and 1988 than GNP. Outlays will grow more slowly than GNP, not more rapidly.

Senator Grassley. OK.

Dr. Feldstein. And they will shrink as a share of GNP from 25 percent in 1983 to 23 percent in 1988.

Senator Grassley. Those are trends that I want to accomplish in budgeting, but another principle I have is that if the real economic growth of our economy is 3 percent, then the budget should be 3 percent.

In other words, the expending tax base——

Dr. Feldstein. Between 1983 and 1988, the economy will grow more rapidly than real Government spending.

Senator Grassley. Well, maybe I am wrong, but beyond 1984, I thought the real growth of the budget was 7 percent, and that 7 percent——

Dr. Feldstein. No, that is not true. One way to summarize it, is to just tell you what happens to the percentage of GNP that goes into Government spending.

In 1984, it is 24.3 percent. In 1988, it is 23.0, and along the way it shrinks each year so that Government spending is going up a little more slowly than GNP is going up, in both real and nominal terms.

Senator Grassley. All I was doing was quoting from Stockman's testimony that we had an average 7-percent growth in the budget in the outyears.

Dr. Feldstein. That must be nominal. That must be not adjusting for inflation. I do not know that number. Yes, I can tell you that number. Between 1984 and 1988, total outlays nominal, not real, total outlays are going up at 7.4 percent between 1984 and 1988.

Now, between 1984 and 1988, roughly speaking, this is what happens to nominal GNP: 9 percent, 8.9, 8.7, 8.5, 8.5. So in each year nominal GNP is growing more rapidly than outlays.

Senator GRASSLEY. Mr. Chairman, I might follow up when he is done with an additional question but that is all I have right now.

LET MONEY GO TO REDUCING THE DEFICIT

Senator GORTON. I do want to follow up on something which Senator Grassley asked you. You told him that if it turns out that the economy performs better this year than the projects in the President's budget, you would prefer that the money go to a reduction of the deficit rather than to be spent.

I take it that you feel that that kind of reduction in the deficit would be translated into greater growth in the economy in the outyears.

Dr. FELDSTEIN. Absolutely.

Senator GORTON. This is the real reason that we want to reduce deficits, is that not correct?

Dr. FELDSTEIN. Sure. As I said in my prepared statement, the larger deficits are a drag on our capital formation. They are a drag on our ability to create more productivity and higher real incomes and higher real wages.

Senator GORTON. And so the reason for us to discipline ourselves is so that real growth will be greater?

Dr. FELDSTEIN. Absolutely.

Senator GORTON. I am looking at your table 1, Dr. Feldstein, and I believe that the line 8, receipts, when we get out to 1988 assumes that the standby tax increase has in effect been implemented.

Dr. FELDSTEIN. That is correct, yes. That includes the standby tax increases.

Senator GORTON. And you would expect, on the projections you make, that the conditions for that standby tax increase will, in fact, trigger it in 1985?

Dr. FELDSTEIN. That is correct, yes.

PROPOSAL SUBMITTED IS A GOOD ONE

Senator GORTON. Do you feel as an economist that the form in which you have submitted that tax increase is the best form, the form least likely to slow down economic growth, as opposed to some other form of taxation which would produce the same amount of revenue?

Dr. FELDSTEIN. I think that the proposal is a good one. I cannot think of a better way of achieving that extra revenue.

Senator GORTON. It is better, for example, than a basket of excise taxes?

Dr. FELDSTEIN. I find baskets of excise taxes have all kinds of distorting problems of shifting demand helter-skelter among different kinds of goods and services.

Senator GORTON. Now, I came in late for which I apologize, but I understand that in answering a number of other questions, that you have been very strongly opposed to a repeal or perhaps even a deferral of the indexing provisions contained in the 1981 tax cut.

Dr. FELDSTEIN. That is correct.

Senator GORTON. Would it be accurate to describe your testimony as saying that might be the worst of all the tax choices we could make as opposed to the ones that the budget includes itself?

Dr. FELDSTEIN. I would say that. I would really say that. I think that it would do tremendous damage to the credibility of the anti-inflation program. It would be as contrary to the notion of keeping taxes down as anything that I could imagine. It would simply be a signal that the Government wants to have a ready source of growing tax revenue in future years and moreover would make that growth faster if we would have more inflation.

ADMINISTRATION OPPOSED TO EITHER CHANGE

Senator GORTON. This, I suppose, is a very difficult question because you are, obviously, an adviser to the President. But on the assumption that the Congress decided to go to a different method of finding additional revenue, would you find a postponement of all or a portion of the third year of the tax cut to be less bad than a repeal or a postponement of indexing?

Dr. FELDSTEIN. The administration is very clear that we oppose either of those changes.

Senator GORTON. I understand that. I am just taking the choice between two bad ideas from your point of view.

Dr. FELDSTEIN. I do not have the Solomonic wisdom to make that choice. I am going to pass on that question.

Senator GORTON. I rather suspect you do have the Solomonic wisdom to make that choice and feel constrained not to do so. I do not feel the same constraints. I think my answer would be what yours would be if you could answer the question.

Dr. FELDSTEIN. I hope you are right.

Senator GORTON. Back to table 1, and I am looking again at the 1988 administrative budget line, the 2.4-percent deficit, since this table does not include some of the other prerequisites for that, what is your projection of unemployment in 1988?

STRUCTURAL FULL EMPLOYMENT LINE

Dr. FELDSTEIN. I think it is 6.8 percent for the year.

Senator GORTON. And that sounds fairly close to what you would consider to be the structural full employment line?

Dr. FELDSTEIN. Right.

Senator GORTON. So is it appropriate to say that this 2.4 percent is what we now call the structural deficit.

Dr. FELDSTEIN. Yes.

Senator GORTON. It is the deficit that we do not know how to get rid of no matter what we do?

Dr. FELDSTEIN. It is a structural deficit.

Senator GORTON. How are we going to get rid of it? Give us your best economic advice now. What do we do about that 2.4 percent, or is it irrelevant?

Dr. FELDSTEIN. No, it is very much relevant, and it is a question of speed and how rapidly we do eliminate these deficits. But continuing along the same path—you do not see the years between 1980 and 1988 on this chart, but I have them in front of me here—the deficit is coming down rapidly: 3.6 in 1986, 3.2 in 1987, 2.4 in 1988.

Part of that is the recovery, but part of it is the natural tendency of higher economic growth to produce more revenue, so that if we just hold the line on real Government spending——

Senator GORTON. Let me carry that out. At the time at which the deficit figure is zero, is it because total outlays are lower than 23.0, or receipts higher than 20.6, or both?

SQUEEZING DOWN THE SIZE OF THE DEFICIT

Dr. FELDSTEIN. Both. If we froze the current service levels of activity, real activity, at the levels provided for in 1988 by the administrative budget, two things would happen. As the economy grew, outlays would get to be a smaller and smaller percentage of GNP. Also, because our tax system has some bracket creep in it even when there is indexing, because there is bracket creep associated with the real growth in the economy, taxes as a share of GNP would rise.

So we would have both of those squeezing down the size of it.

Senator GORTON. Have you projected out beyond 1988?

Dr. FELDSTEIN. I do not know that offhand. We only project out to 1988. I do not have economic forecasts beyond that.

Senator GORTON. Does even that projection of a zero deficit mean that we have to freeze, in real dollar terms, nondiscretionary and nondefense spending forever?

Dr. FELDSTEIN. No, no, the faster it grows, the longer it takes to get to that. You do have this slight increase in taxes that continues into the future, and you have the real growth. If the real growth continues in the 3- to 4-percent range for that period, you can have room for growth of nondefense spending, as well.

1988 ADMINISTRATIVE BUDGET NOT FROZEN

Senator GORTON. What about that 1988 administrative budget as it relates to nondiscretionary, nondefense spending, and then speaking at this point not so much as a percentage of the gross national product, but has it, in your projections, been frozen at roughly the same dollar level that it is in 1984 through this entire 5-year period?

Dr. FELDSTEIN. No. Let me give you the numbers, if I can find them here. Nondefense——

Senator GORTON. Nondefense, nonentitlement discretionary.

Dr. FELDSTEIN. Well, nondefense excluding OASDI, so it has medicare in it—I do not have that broken out here—between 1984 and 1988, increases by $50 billion a year. It goes from $322 billion to $370 billion.

Senator GORTON. $50 billion a year?

Dr. FELDSTEIN. The annual rate—no, not each year, it does not go up—but the annual rate goes up by $50 billion. The annual rate in 1984 is $322 billion. The annual rate in 1988 is $370 billion.

Senator GORTON. But that entire increase is going to be taken up by other entitlements, is it not, if only OASDI is taken out of that figure? Does that includes military?

Dr. FELDSTEIN. No, no, no. The defense is separate. The interest is separate. I thought you said you wanted nondefense, noninterest, excluding the entitlement.

Senator GORTON. No, nonentitlement. That is to say, nondefense, discretionary.

Dr. FELDSTEIN. Right, nondefense, nonentitlement. The only entitlement I can break out, with the numbers I have in front of me, is the OASDI, which is, by far, the largest. That will be a quarter of a trillion dollars in 1988, so that nondefense, noninterest, nonold-age survivors and disability insurance goes from $332 billion to $370 billion.

Senator GORTON. Do you think that it is either realistic or just for us to say that we are not only going to have a 1- or 2-year freeze in nondefense, nonentitlement spending, but a permanent freeze in this area, including all our capital improvements and all of the nonentitlements, the health, education, and energy programs, and the like? That is not realistic budgeting or projecting, is it?

HAS SPENDING GROWN TOO RAPIDLY

Dr. FELDSTEIN. I do not know what realistic means here. It is obviously a question of choice that the Congress will face. But when I look at this table that I put in my testimony, I see that nondefense, nonentitlement, that is to say, excluding OASDI and excluding medicare, went up from 6.8 percent to 9.1 percent between 1970 and 1980. It is a dramatic increase as a percentage of GNP.

The question is: Can we work our way back on those programs to the same share of a much larger pie, or a much richer country? We do not have to pay for two Presidents of the United States. We only have to spend that once, and so on. A lot of things are fixed costs that are part of nondefense, nonentitlement spending, and the issue, I think, that Congress is being asked to address is whether we have allowed that spending to grow too rapidly.

Senator GORTON. Well, I suppose my frustration is that you are still hiding a lot of entitlements in this figure when you have taken out only OASDI and medicare. Let me be more precise.

Do you feel that we are spending now an appropriate percentage of our gross national product on the capital infrastructure of the country? Whether that relates to highways or other transportation systems, or water projects, to scientific and technological education, to research outside of the field of national defense, if it is to the investment in our future capital, is that percentage of the gross national product appropriate now?

Dr. FELDSTEIN. I would say that that kind of spending should be done primarily in the private sector, and that is where it is primarily done, in the private sector. There are certain exceptions.

Senator GORTON. Highways are primarily——

FUNDING QUITE SUBSTANTIAL

Dr. FELDSTEIN. No, not highways, but capital more generally, and, of course, a lot of the highways are properly the responsibility of the State and local governments. But this administration did just introduce, and Congress passed, a \$5 billion-a-year program to deal with those highways.

Senator GORTON. We are quite aware of that.

Dr. FELDSTEIN. Right; so there is no lack of interest in those highways. As far as science goes, I think—I cannot remember the exact number—but the increase in National Science Foundation's funding was really quite substantial this year, and I think the scientific community is very supportive of what the administration is doing for science quite apart from the scientific spillovers that come out of the defense establishment.

Senator GORTON. It is a good answer, but not quite completely responsive, but I agree in every one of these things. Obviously, I supported the highway tax increase. I think what you are doing with NSF is fine. But I still wonder whether or not you think that those two increases put spending on that kind of capital investment at their optimum level?

Dr. FELDSTEIN. Given the other constraints on our budget, given the size of the deficit, given the inability to cut back on other kinds of spending that we would rather not be doing, I am afraid the answer is yes.

Senator GORTON. All right. I will accept that for this point. Thank you, Mr. Chairman.

Senator GRASSLEY. Mr. Chairman, I have one last question.

EXPLOSION OF MONEY SUPPLY

I want to talk about the explosion of money supply, M_2 particularly. At least twice and maybe three times in the last 4 years, after a lag of about 90 days following an increase in the money supply, then the interest rate would go up fairly dramatically to an all-time high.

Do you expect that to happen in 90 days from now?

Dr. FELDSTEIN. No, I certainly do not. I am not a betting man, at least not these days, but if I were, I would be willing to bet quite a lot that interest rates would not go up to all-time highs 90 days from now.

Senator GRASSLEY. Then, the expansion of the money supply that we have had, from the standpoint of the two or three previous times it happened, you expect that pattern not to be followed this time, and has there been something done to see that that pattern does not happen again this time?

Dr. FELDSTEIN. Yes, I think that is a very important question that you raise. I think the M_2 growth last year and the year before were just slightly above the top of their target range, and were not a problem, and were consistent with the gradual decline in inflation that we have experienced.

But as you know, Congress enacted a major change in banking legislation, that took effect in December 1982. That had the effect of attracting a lot of funds that otherwise would have been outside the banking system, into M_2. What we saw in January was about a 2½-percent increase in the stock of M_2. It went from about \$2,000 billion to about \$2,050 billion as additional money was brought in.

The way we report that number, of course, is to take that 2½-percent level increase and turn it into an annual rate by multiplying it by 12, So we get a 30-percent increase in M_2. That looks frightening, but fortunately, people in financial markets knew this was happening, understood what was going on. And we saw this week, in the way the bond markets have responded, that they were not upset by this, and recognized it really was a shift of funds rather than an increase.

Senator GRASSLEY. But do not forget, though, that still comes in conjunction with the expansion of money supply that has happened in the last 90 days.

Dr. FELDSTEIN. Not so much in M_2. I mean M_2 has really behaved in a quite stable way during the preceding months. M_1 was going up more rapidly, but I would say for rather different reasons associated with the sharp fall in interest rates that occurred.

UNCERTAIN PERIOD EXISTS FOR NEXT FEW MONTHS

Senator GRASSLEY. So you don't see, then, that uncertainty in Fed policy, that sometimes breeds an increase in interest rates, is any problem today like maybe it was——

Dr. FELDSTEIN. No, I think there is a problem, but the problem is not the increases that have occurred in the M's. The problem is that we are in an especially uncertain period for the next few months. Thus, it is very hard for anybody to know how much of the increase in the money stock really is due to a shift.

Senator GRASSLEY. Well, then, in a period of uncertainty, then, it is necessary that the Fed and the administration, and maybe, to some degree, even the Congress, take necessary precautions so that we build some competence in a period of uncertainty.

Is there some things being done that will lead to that?

Dr. FELDSTEIN. I think the key thing is that Chairman Volcker announced yesterday, that once this brief transition period is finished, he intends to go back to monetary aggregate targeting, and has announced what the targets are going to be, and I think that is very important.

Senator GRASSLEY. OK. Thank you, Mr. Chairman.

Chairman DOMENICI. Senator Quayle?

Senator QUAYLE. Yes, thank you, Mr. Chairman.

I guess my question sort of follows along the line of Senator Grassley. I really believe the major element that would choke off the recovery that appears to be underway, would be a return of high interest rates.

If, in fact, in the next couple of months, some of the major banks shoot up the prime rate, or shoot up the interest rate even a half a percentage point or a point, that is just going to really almost shell-shock the financial community, and small business, and could have a very detrimental effect on the entire economic recovery picture.

MONEY GROWTH RATES

From your response to Senator Grassley, I understand you to say that Volcker is going to sort of put us in a period of waiting the next couple months to sort out the monetary policy. Beyond that, after the next couple of months, he is going to go back to specific targeting of the monetary policy. Is that basically what is going to happen in monetary policy?

Dr. FELDSTEIN. The Fed announced yesterday that the FOMC decision was to allow, for M_2, a 7- to 10-percent money growth range, taking as the base the average level of M_2 in February and March, contrary to previous years where the procedure has been to take the average level in the fourth quarter of the year as the base for the next 12 months.

They were recognizing that we are going through a transition period in which the new levels, new normal relations between M_2 and nominal GNP will be established. They will take that as the base for guiding the money growth rates during the remainder of the year.

Could I go back to your previous statement about the risks of a small increase in interest rates and the fears that that might create in the financial community? I think, in fact, I know that an increase in interest rates is a very normal thing to happen in the beginning of a recovery.

During the postwar recoveries, the first 12 months saw an average increase in Treasury bill rates of 1.2 percent. In only two of the seven recoveries did Treasury bill rates not go up during the first 12 months.

Moreover, the futures markets indicate that the financial community is betting on an increase in Treasury bill rates and other short-term interest rates. So they would be very surprised if interest rates did not go up during the next little while.

I think much more important is what happens to long-term interest rates, and that brings us back to the concerns about the size of the deficit in the outyears.

PRIME RATE NOT A GOOD INDICATOR

Senator QUAYLE. But the short term and the T-bills, if they go up, do you think that there will be a corresponding increase in long-term rates, particularly the prime rate? I mean that is what everybody sort of focuses on. That is what my concern is. As we get this thing steamrolling in the right direction, and then all of a sudden the prime goes up——.

Dr. FELDSTEIN. I do wish that everybody would stop looking at the old prime. The prime certainly is not what it used to be. It is not the rate at which prime borrowers borrow, and it is not a very sensitive indication of where money market interest rates are.

Senator QUAYLE. Which one should we be looking at?

Dr. FELDSTEIN. I would look at Treasury bill rates, or commercial paper rates, as an indication of what is happening at the short end of the market, and I would look at 30-year Government bonds as an indication of what is happening at the long end of the market.

I think the critical question is what happens to those long rates. I think we could, over the year ahead, see that short rates could go up a little bit. It is perfectly possible as part of the recovery. Yet, we can see long rates coming down if financial markets have confidence that the deficit is going to be under control and that we are not going to move into a new period of higher inflation in the future.

It is very important to bear in mind that we have really only had about a year of good news on inflation. 1981 was a year of still substantial uncertainty about just what inflation was doing. All the dramatic increases, that have created so much confidence already on the inflation front, happened in 1982, and it is very important that that be reinforced and that that continue.

3 OR 4 PERCENT REAL INTEREST RATE POSSIBLE

Senator QUAYLE. Do you think that we will ever see a return to the historic average of real interest rates of around 3 or 4 percent?

Dr. FELDSTEIN. That is certainly possible. There is no reason why we should not see real interest rates, long-term interest rates go down to the 3 or 4 percent real level. I think they are high now because of the inflation fear primarily, and as that fear gets corrected, I think we will begin to see it. In other words, when there is not such a discrepancy between the current inflation rate and the rate of inflation that financial market participants are afraid are going to prevail in the future, then I think we will see long rates come down relative to the existing inflation rate.

Senator QUAYLE. But we still have about a 10-percent, 8 to 10 percent real interest rate. We have had that now for 12 months, 16 months. I presume you are saying that we are going to have that a while longer.

Dr. FELDSTEIN. Confidence takes a long time to build.

Senator QUAYLE. A $200 billion deficit, as far as fighting inflation, is concerned—is that not a nervous indicator we are sending out there?

Dr. FELDSTEIN. Well, my impression from talking with people in the financial and business community is that they understand that the short-term deficits are, first of all, in large part a cyclical phenomenon, and beyond that, cannot be changed by Congress. You cannot do anything to eliminate a $200 billion deficit in 1983.

They are more worried about what Congress is going to do in future years, and what kinds of pressures will be put on the Fed to bring down interest rates through monetary expansion. And as they become convinced that the Congress intentions are to shrink the outyear deficits, and that there will not be pressure on the Fed to try to bring down interest rates by expansionary monetary policy, as those two things happen, then I think we will see long-term interest rates coming down.

POLITICAL PRESSURE MOUNTING

Senator QUAYLE. Is there any other way to bring pressure on the Fed to see interest rates come down other than an expansionary monetary policy?

Dr. FELDSTEIN. I think you are saying is there any other way the Fed can bring down interest rates other than by an expansionary monetary policy. I would say they cannot bring down interest rates, but that is the form the political pressure typically takes. The pressure takes the form of saying to the Fed, "Why don't you give us some more money," because if the Fed does give some more money, then you can get a little bit of temporary relief on short-term rates. But at the very same time, long-term rates can start moving up.

The Fed could be tighter now. The Fed could say, "No, all we care about is inflation. We are prepared to let the recovery go. We are going to bring down inflation." That might bring down long-term interest rates, but that is not a price worth paying.

I think the Fed is doing just the right kind of balance between maintaining a basis for sound economic growth, and yet preventing a runaway of inflation.

Senator QUAYLE. But from the political point of view, there is a certain amount of a time element—what you call patience. At some time, that patience is just going to wear to a point where there is going to be pressure. And I suppose that the only way——

Dr. FELDSTEIN. That is what the financial markets are worried about.

Senator QUAYLE. Yes, but I would hope that in the communications from the White House, the Fed, there is a realization of the political pressures that are being mounted on these interest rates, because I think I am not alone. I think that there are other people that are really focusing in on that as a major stumbling block to recovery, because, as you say, we are going to accept a short-term cyclical deficit.

Congress is only going to be able to deal on a short-term basis with fiscal policy. As far as long-term policy and making sure that that recovery is going to come, we have no alternative but to focus on the monetary policy.

And when we start to focus on monetary policy, if you consider that the Fed's independence is a factor, political pressures are going to build. I can only just say that as a caveat. Counselor, try to bring that message loud and clear.

Dr. FELDSTEIN. I would say, Senator, that there is nothing that the Fed is doing now that is keeping long-term interest rates high. I think that the Fed's actions are consistent with bringing those rates down if only the Congress will indicate that its budgetary policies are consistent with smaller deficits in the future.

CONTINGENCY TAX ON WAY IN

Senator QUAYLE. I have one final question, Mr. Chairman.

By proposing a contingency tax, which I understand does not go into effect unless there is a 2- or 2½-percent disparity of deficit of GNP; I guess that the spending side of the ledger would have to get down to about 22, 22½ percent, or even below——

Dr. FELDSTEIN. Twenty-three.

Senator QUAYLE. Get down to 23 percent? The revenues are going to be 21 percent, or 20½ percent by 1986? I did not think they were going to be that high.

Dr. FELDSTEIN. If you put it on, it is 20½.

Senator QUAYLE. If you put it on, it is 20½, but if you do not, if you are going to say that the contingency tax is not going to trigger in, then you are looking even at the lower revenue figures, and I think there is a basic admission there that unless you get a real strong recovery, the contingency tax is going to get in.

Is that basically an admission or a subtle statement to us that we are in an undertaxed economy, that we really are going to have to raise revenues, and broaden the revenue base in the future by putting in this contingency tax?

Dr. **FELDSTEIN**. Well, the contingency tax is there because we believe that additional revenue is likely to be necessary, but we do not want to have that revenue if it is not absolutely necessary.

Senator **QUAYLE**. So we are, in essence, an undertaxed economy as we look on it as straight projection or straight-line forecast——

Dr. **FELDSTEIN**. I do not find those words easy to make come out of my mouth.

Senator **QUAYLE**. I know that, but maybe it is sort of a subtle hint of that implication. These communications, messages that are sent up to the Hill all the time—Bill Biden knows about messages; he sends them all the time—but this seems to be a little message to Congress that really we are an undertaxed economy.

Dr. **FELDSTEIN**. We are an overspending economy, so we cannot be an over-deficit economy.

Senator **QUAYLE**. Well, we are overspending and undertaxed.

Senator **CHILES**. I read it as a message, "Help us help ourselves."

Senator **QUAYLE**. Help us help ourselves. But it certainly implies that——

Dr. **FELDSTEIN**. But as the table in my testimony shows, the administration now forecasts a higher level of receipts, 20.6 percent of GNP in 1988 under our budget. This is a higher level of receipts than we have at the current time, and we see that as necessary, at least as of that date, in order to get the deficit down to manageable proportions.

But just as we propose relative to the current baseline budget an increase in receipts of a little less than 2 percent, we also propose outlay reductions of about 2 percent.

Senator **QUAYLE**. Thank you, Dr. Feldstein.

Mr. Chairman, I might just point out that the reason that he was a few minutes late this morning is because he was before our committee, and we did not release him promptly before 10 o'clock, so I hope that——

Chairman **DOMENICI**. We were all late.

Senator **QUAYLE**. Oh, you were all late; good.

Chairman **DOMENICI**. Senator, can you stay for a couple of minutes?

Senator **QUAYLE**. Oh, I would be delighted to stay to hear Senator Biden. I always enjoy his remarks.

CEA REPORTS PESSIMISTIC ON JOBS' BILL

Chairman **DOMENICI**. Senator Chiles had one question, and I have two. Then, I am going to yield and let you chair.

With reference to the Government getting involved in programs to aid the unemployed in some short term or permanent way, so-called jobs' bills, I understand that your reports, that is, the CEA reports, have been very pessimistic in terms of analyzing the effectiveness of Government programs in aiding the unemployed in any permanent way.

Have you changed your mind on that score? And, if not, we met this morning informally with the group that meets every couple of months, that worries about the budget. Senator Chiles was there, three or four other Senators, a couple of House members. I was very pleased to note that it seemed that both sides, Democrats and Republicans, were very concerned that everyone seems to be running to see where they could come up with the newest idea of a so-called jobs' bill, both short term and more permanent.

What kind of limits should we be thinking of? Ultimately, are we going to have to fit them in our targets or not? What do you recommend to us about that?

Dr. FELDSTEIN. I certainly have not changed my views from the views we expressed in our economic report earlier this year. I think that the proposals for structural policies that were contained in the state of the Union message, that will be coming up in legislation soon, are prudent, focus on the critical problems—the problems of the disadvantaged, and the long-term unemployed—and provide significant funding within the framework of the Job Training Partnership Act that Congress passed last year.

More recently, we have begun discussions, as you know, about whether it would be useful to do some further things at this time. There seems to be some growing agreement, although not yet a final agreement, that it would be worthwhile at this point to provide some additional funds for certain humanitarian activities.

They are quite limited, but nevertheless, are worthwhile, and would not increase the cumulative deficit over several years. I would emphasize, as I know the administration more generally will, this idea that we are not talking about increasing the overall size of spending on these activities, but just doing them in 1983 rather than in 1984 or 1985.

The administration will not seek additional budget authority, and will seek to shift that activity explicitly, meaning spending the money now, and not spending the money in 1984 and 1985.

STANDBY TAX

Chairman DOMENICI. My last question has to do with the so-called standby tax. I was pleased yesterday afternoon to hear Stan Fisher from MIT, whom I do not know well. I asked after the meeting. And I am sorry that I do not, because I should have known about him. Obviously, he is a rather renown economist, and I think might have been chosen because he does not engage in the typical hearings up here, and is not known to be a supply sider, or favor this policy or the other, but as an economist, he suggested that the idea was a very appropriate one.

I guess I am the only one around that has said it sounds good. Let me tell you what I see is the problem with it. I think Congress is really ready to bite the bullet on changing the revenue base in some way. They are looking at existing reductions, and saying why don't you defer them.

I have spoken to indexation. I tend to agree with you philosophically, but I am not nearly as worried about some deferral of it, or some formula that would buttress against the concern you have, which is principally with high inflation. It is an invitation to large amounts of revenue without passing any tax laws.

So I think there are all kinds of ways of guarding against that. But I think the reason that it is not gaining any momentum is because it is very difficult for anyone to understand exactly how you pass a conditional or standby type tax.

I think it would be appropriate for us to have more detail on it quicker. I mean the theory is that you all do your job, and we will send you a standby proposal in 3 or 4 months. Well, we do not know what that is going to look like, and so everybody is going to get fixed on some other approach.

At this point, we do not pass taxes up on this committee regardless of all our noisemaking about which we prefer. We send a message to the Finance Committee through the Congress, if they choose to vote the resolution in that says either lower or higher taxes, and if we do it by reconciliation, we literally order the change.

Now, you see the problem we have. How do we order a change that is conditional in terms of this committee? And yet we have yet to work out with the Finance Committee. If they want us to direct in a resolution that the tax revenues be increased, we could do that. We did it. That is how they got the $98 billion. We literally mandated an increase in each of the years, and gave them so much time to pass it, and then the Congress agreed with that proposition.

Senator Dole and his committee wrote the bill. It seems to me you are not going to get anywhere until you make it specific, and, second, that instead of conditioning it in, that you can consider conditioning it out. That is, that it is a tax, that it is fixed whether it is your surtax, or whatever, and there is an opportunity to take it out if economic conditions are right.

GIVING THE CONTINGENCY TAX A PRECISE FORMULATION

Dr. FELDSTEIN. I think that was very useful for me, and I will go back and relay both of those comments to my colleagues. I think it, frankly, is not a consideration that we had been sufficiently concerned about, giving the contingency tax a precise formulation, because it did not seem to us to be such a difficult problem, but it obviously makes it easier for Congress to consider the idea if we send up a more specific description of how it would work.

There certainly are enough other things that are triggered and either existing or in law now. The way the social security trust fund agreement was worked out by the Blue Ribbon Commission has a triggering mechanism in it. Indexing is a form of triggering. So I have no doubt that we could do it.

The question of whether you have it out unless, or you have it in unless, I think is really just a verbal point. In some sense, you probably have to pass a tax rather than a nontax. The way we have described it in the budget, we have it in, so that I do not think there is any difficulty with the administration proposing this as a tax that would be on the books, but would not go into effect if something happens, or if it came off if the deficit would otherwise have been less than 2½ percent. But I will discuss that with my colleagues.

Chairman DOMENICI. Senator Chiles?

NUMBERS DO NOT BEAR OUT CLAIMS

Senator CHILES. Dr. Feldstein, I heard you saying, as I have heard many of the administration witnesses say, that the large tax cuts were not too large, and they are not the cause of structural deficits. It looks like to me that the numbers do not entirely bear that out. But your argument is that the tax burden as a percent of GNP was not taken below the 1960 level, but I think you failed to mention what has happened since 1960.

First, we took on some major social responsibilities: medicare, aid to college students, child nutrition, and those responsibilities cost about 3.5 percent of GNP. To date, I have not heard anyone, including the President, who wants to eliminate those programs.

So we have added 3.5 percent of GNP basically to those programs, and therefore we would have to do something in the tax situation if we are going to finance those. Your other argument is that defense is not the cause, since we are just taking it back to the 1960 share. But if you increase the defense share and you do not eliminate those new programs that we have added on, then there is no net reduction in spending. So, obviously, there is not any room for a tax cut, but we have made a tax cut anyway.

The other thing that I think your tables fail to take into account when you show all of this magic of where the increase came from, is the change in demographics. A lot of the programs that we are paying more for is due simply to having more old folks, and we are getting more every year. We are getting more into numbers in many of these programs that were set up on the basis that as you increase the numbers, you increase the costs, so is it not an exponential rise in these costs other than the demographics itself and the fact that you have created these new programs.

ADMINISTRATION'S BUDGET SPEAKS FOR ITSELF

Dr. FELDSTEIN. Well, I think that the—let me start with the tax increase—I think that the administration's budget on that point speaks for itself. We are talking about receipts of 20.6 percent higher than the share in 1980. so that we can hardly be accused of creating a deficit by cutting taxes when taxes have gone up, not just in dollars, but as a percentage of GNP.

I think that reflects, just as you said, the reality of the growth of various transfer programs that have been put in place over the last several decades, and that are a permanent part of our economic landscape and have to be financed.

It is true that part of the increase in the costs of the social security program has been the changing demographics, but it is not the largest part by any means. The increase in benefits per retiree relative to earnings' levels in the economy has been the principal reason for the increase in our spending on social security.

I do not remember the figure exactly, but I think, roughly speaking, a third of current outlays reflect the increase in benefit levels since 1970 relative to the increase in private wages, earnings, over that period. If we had maintained the same ratio of social security benefits to wages that we had in 1970, if we had not had the problems of mistakes in indexing formulas, and all that, in the seventies, our outlays in that program would be about a third lower than they are today, and our deficit in 1988 would be about a percent and a half of GNP lower than it is today.

Chairman DOMENICI. Senator Biden?

Senator BIDEN. Thank you.

INDUSTRIES PRINCIPAL PROBLEM IS THE BUDGET DEFICIT

I will not keep you very long, Doctor. I have one question. In your testimony—if this has been asked already, please just refer me to the record, and I will be happy to cover it there—in your testimony, you say, "To put it bluntly, it is not clear whether a recovery would be long sustained if such key industries as steel, construction, and chemical remain severely depressed."

Now, the context in which you say that seems to indicate that lowering budget deficits is the answer to a healthy steel industry. Is that what you mean? And if it is not, I thought that steel and the other smokestack industries had other problems like foreign competition.

I mean what are you implying there?

Dr. FELDSTEIN. These industries do have multiple problems, but I think the principal problem, that I was referring to there, is the budget deficit. But now you correctly ask what about foreign competition, and then the question is, well, why are they having these problems with foreign competition? And my answer would be that the dollar has gone up about 30, 35 percent over the last couple of years relative to the real value of the yen, the mark, the pound, and so on.

And why did that happen, why are we seeing such an extremely sound dollar? Everywhere I have been in the world, they say to me the dollar really is unusually high, unusually strong.

I think that has happened because we have these very large budget deficits. Our large budget deficits are keeping up real interest rates. They are attracting funds from the rest of the world, and in that process of attracting funds from the rest of the world, they are keeping the dollar extremely strong.

So ultimately, I trace back the problems of our export industries, and of our domestic industries that have to compete with imports from abroad, to the large budget deficits that we face in future years.

Senator BIDEN. Thank you very much. Thank you, Mr. Chairman.

Senator QUAYLE. In other words, you also say that the strength of the dollar is predicated upon the——

Dr. FELDSTEIN. Budget deficits.

Senator QUAYLE. On the budget deficits. Is that because of some of the pressure on interest rates——

Dr. FELDSTEIN. Exactly. The real interest rate, the real long-term interest rate subtracting funds from abroad. Another simpler way of sort of cutting through all this financial market stuff and seeing what is really going on, is that if we run these large budget deficits, we have to finance them. We finance them by crowding out private investment in this country, but we also finance it by sucking in funds from abroad.

But if we bring in those dollars, that has to represent goods that we are bringing in from the rest of the world, as well, and not paying for, or things that we are not selling to the rest of the world. So that our budget deficits and the borrowing that we have to do, and the financing that comes from elsewhere, all boils down to saying that we will export less, and we will import more from the rest of the world.

FOREIGN COMPETITION TO CONTINUE BEING SERIOUS PROBLEM

Senator **Quayle**. But in the short term, we are going to have large deficits even by your calculations, so in the short term, we are going to have a strong dollar, and a weak yen and mark and pound; therefore, that the foreign competition is going to not get any better.

Dr. **Feldstein**. In the short run, the foreign competition is going to continue to be a serious problem. The dollar could turn quite quickly, just the way financial markets in general can turn quite quickly. So that if markets become reassured, if long-term rates start down here, we will also, I think, see the dollar falling relative to other currency.

That will not have an immediate impact on our exports and imports. Historic experience shows that that is something that takes almost a year or more before it begins to have its full impact.

Senator **Biden**. May I follow on with one other point?

Senator **Qayle**. Certainly, go ahead.

Senator **Biden**. Doctor, yesterday, the Secretary of the Treasury was here, and I asked him a question I am sure he had been asked 40 times before and since. That was, he had been quoted in the New York Times as talking about the real interest rate, as being a consequence of, in large part, the profit motive, banks, and that notwithstanding the deficit and the so-called risk factor, that that gets factored in in calculating interest rates by the major bank because of that deficit and their concern about crowding out, and all of that.

He argued that there was a relatively large portion, as I understood it, of that what is, in essence, a 7-percent real interest rate; that much of that was a profit motive because of—he made the point—because of a number of the bad loans that many of these major banks made. They are picking it up on the other end.

Now, if that is true—and I, first of all, wonder whether or not you would think that is true—what makes us think even if we get that deficit down, trending in the right direction, that in the near term, banks are going to see fit to deal with the, quote, "real interest rates?"

INTEREST RATES DIFFER

Dr. **Feldstein**. Well, I did not hear Secretary Regan's remark, so I cannot comment on it directly, but I can comment on the general question that you raise.

First, talking about rates in general is very different from talking about the rates charged by banks. Commercial paper rates, Treasury bills, long-term bonds, all that is out there in the financial market.

Senator BIDEN. I am specifically talking about banks.

Dr. FELDSTEIN. Now, the banks themselves do an awful lot of lending below the prime rate. Customers, that in the old days could get what would be called prime rate lending, can now let commercial paper rates, and so can come to the banks and say, "Either you fellows lend to us at the kind of 8½ percent rate that we can get out there on the markets, or we will take our business elsewhere," and the banks, of course, are subject to competition like any other business.

So what we are really focusing on is the prime rate. The prime rate is still a strange rate, and exactly who pays prime and who pays below, and who pays above and how much above, is one of those great mysteries of banking, that someday I will understand.

Senator BIDEN. Do we have any way of measuring that?

Dr. FELDSTEIN. Yes, there is information on the distribution of rates, but not, of course, on who is paying it. So it is not clear how you interpret that information. Banks are ultimately competitive businesses, and the fact that they took a loss once before does not allow them to make abnormal profits now just because they would like to make abnormal profits. But it is true that the banks are very concerned about the state of their portfolios and about the implicit losses in some of the overseas loans that they have made. So they are reluctant to seek out additional business, especially business that is not of the highest quality.

I think that is a very important consideration, and it is really that which is causing them to keep their interest rates high. They are trying to build up reserves, and they are not keen to take additional risks.

Senator BIDEN. That answers my question. I appreciate it. Thank you.

Senator QUAYLE. Thank you, Dr. Feldstein.

[Whereupon, the committee adjourned at 12:21 p.m. to reconvene on Friday, February 18, 1983, at 10 a.m.]

INTERNATIONAL AFFAIRS

TUESDAY, FEBRUARY 22, 1983

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met at 10:42 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Kassebaum, Boschwitz, Symms, Grassley, Kasten, Chiles, Biden, Johnston, Sasser, Metzenbaum, Riegle, and Exon.

Staff present: Stephen Bell, staff director; Charles Flickner, senior analyst for international affairs; Richard N. Brandon, minority staff director; and Richard Koskella, analyst for international affairs.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman DOMENICI. The hearing will please come to order.

Mr. Secretary, I am pleased to welcome you to the Budget Committee and I particularly appreciate your fitting this hearing into your busy schedule. I am told that you personally prepared the excellent written testimony that was submitted several days ago. Not only do I appreciate the excellence of the testimony, but I appreciate the fact that even with your schedule you were able to submit it to us in advance in the hearings where Senators have had an opportunity, if they desired, to read it. That is always helpful.

This morning's hearing is a unique event. Although our first chairman left to become Secretary of State in 1980, this is the first appearance by a sitting Secretary of State before the Budget Committee.

The subject of today's hearing is also unusual. This is the first time that the committee has set aside an entire hearing to consider the impact of the international economy on our domestic budget deliberations.

Your personal record of service lends special authority to your testimony on this subject. You have been Secretary of Labor and Director of the Office of Management and Budget. Until your current appointment, you were Chairman of President Reagan's Economic Policy Advisory Board.

You have been Secretary of the Treasury and U.S. Governor of the International Monetary Fund. In the private sector, you served as president of a large international company.

ENCOURAGE AND SUSTAIN ECONOMIC RECOVERY

As this committee begins work on the First Concurrent Budget Resolution for 1984, the biggest challenge we face is to encourage and sustain the economic recovery that appears to be underway. At the same time, we must be careful not to undo our success in reducing inflation.

It is increasingly clear, at least to this Senator, that a sustained recovery in the United States is not possible if the rest of the world falls into prolonged recession. Domestic economic growth has to be backed up by recovery abroad. Our trading partners must be in a position to do more than pay high interest rates on old loans; they need to earn enough to buy American goods and services. Our allies need to be in a position to help pay for the common defense.

There are several developments in the international arena that will have a direct impact on the extent of our domestic recovery. First, the debt crisis in Mexico, Brazil, and an increasing number of smaller countries has reduced confidence in our banking system. It appears that some of our big city bankers and some of their foreign customers stake their future on continuing high inflation and negative real interest rates. Our success in lowering inflation has proved them wrong. It remains to be seen who will pick up the bills—the citizens of the debtor nations, the bank shareholders, or the American taxpayer. Maybe if we do it right, no one.

UNFAIR TRADE PRACTICES AND SUBSIDIES ARE A PROBLEM

A second problem is unfair trade practices and subsidies. Our farmers, miners, and manufacturers can compete in international trade only if the markets are open. Reduction in unfair trade barriers and subsidies abroad will lead to greater exports and savings in our domestic budget. This can occur only if the markets are more open than they are right now.

Rapidly falling oil prices are a third development that we have to take into account. There is news on that front today and I hope that you will address the issue with us. Obviously it is good news. A fall in OPEC prices has some elements of bad news but, for the most part, it is good news. Perhaps you will address both aspects of that to us here on this committee. I hope you cover in your testimony the areas that I have mentioned, and at least the following: First, the role of international trade in the U.S. economy. Second, the current international economic problems we face, expecially the spreading debt crisis. Third, the legislative remedies to alleviate these international economic problems that are under consideration by the Congress or proposed by the administration.

The largest of the proposed legislative remedies is the $8.4 billion appropriation request for the International Monetary Fund. We seek your assurance that this money will be used productively, to help indebted nations recover and grow as our trading partners. As you know, there is concern that much of the IMF money could be used to bail out banks that made questionable loans that were used for consumption or, in some instances, corruption.

We hope you will explain to the committee how the President's request for foreign aid and other international programs helps end the global recession. In a nutshell, we are hopeful that you can convince us that while this is an international use of our money, that it helps the American economy. I cannot stress enough, as I did in a few moments prior to this hearing, how important it is that a number of Senators and enough Senators be convinced of the need for international legislation and appropriations. An implicit decision will be made on that in this budget resolution and if the funds are not in there, it does not mean for certain that it will not be appropriated, but I think it sets a pattern to make passage of your proposals much more difficult.

There are other international programs that are in the President's budget request that are important, but I think I have covered, the most significant, from my standpoint, as it pertains to your role as Secretary of State.

I would be pleased now to yield to my good friend, Senator Chiles.

OPENING STATEMENT OF SENATOR CHILES

Senator CHILES. Thank you, Mr. Chairman.

Mr. Chairman, I would like to put my full statement into the record and say we are pleased to have you with us, Mr. Secretary. As a former Treasury Secretary and now as Secretary of State, certainly you are well qualified to measure American needs certainly in the face of an economically stagnant world.

Free trade, we know, is in our best interest with one out of every six American jobs tied to world trade and accounting for somewhere between 15 and 20 percent of our GNP. Of course, everywhere we look in the world, we see that economic growth is stagnant. Commodity prices are down and the interest rates are very high.

All these things, of course, together have cut deeply into international trade so we certainly have to go about doing what is best for the United States, and a good place to start is to try to get our interest rates down, not just in the short term but as a durable economic policy. One way to do that, of course, would be to try to work on our budget deficits.

I happen to feel that cutting 25 percent of our tax base is going to guarantee us a structural imbalance with spending cuts. We will not be able to shape the spending cuts, or determine when the President's program starts to tackle the deficits. Unfortunately, I am afraid because it waits to tackle them in 1986, 2½ years after the beginning of the recovery. With those deficits so high and continuing to go up, that in turn is going to give us much higher interest on the national debt and a much harder time in trying to deal with those structural deficits.

I also would like to hear what the administration will do if our allies become so hard-pressed that they are not able to fund arms purchases, and if they are not able to, in some instances, make their debt payments and the provisions that they have. Are we better off funding an American defense built at fund-restrained levels or do we have to take a look at our own defense budget in an effort to make sure that we have a stronger economy so we could deal with these kind of problems.

I think these are certainly things that will be of interest to us. We are delighted to have you before the committee today.

PREPARED STATEMENT
OF
SENATOR LAWTON CHILES
RANKING MEMBER
SENATE BUDGET COMMITTEE

SECRETARY GEORGE SHULTZ HEARING
FIRST CONCURRENT BUDGET RESOLUTION
FY 1984

FEBRUARY 22, 1983

We are pleased to have you with us this morning, Secretary Shultz. As a former Treasury Secretary, and now as Secretary of State, you are well qualified to measure American needs against the facts of an economically stagnant world.

It strikes me that free trade is in our own best interests. One in six American jobs are tied to world trade, accounting for between 15 and 20 percent of our Gross National Product.

When we hear about financial trouble in Mexico, we should also listen carefully for what that can mean to the job of someone who builds bulldozers in Illinois. When we hear about financial trouble in Brazil, we must understand that could mean trouble for the electronics workers around the nation whose jobs may hinge on our ability to sell equipment overseas.

So while it's tempting to preach the gospel of a trade war, we should understand that the wages of sin can be unemployment at home. It seems to me that what we really need is to let the world know we are willing to be tough about competition. We should make it known that we are not about to slam the door on foreign trade. On the contrary, we are determined to open the windows, and let the world know the window opens out as well as in.

In short, it's time we all understood our best interests lie in America willing to get moving, not an America simply determined to get even.

We've got to be tough about our own best interests, understanding that free trade is best for us. I'm frankly pleased to see the Administration changing course on the Export-Import Bank. I think it's crucial that we have adequate funds available through the bank even though other nations call it a subsidy. Perhaps it is a subsidy. But unless the Europeans and Japanese see clearly that we are prepared to act, I doubt they will ever get serious about reducing their non-tariff barriers. I've been pushing for a strong negotiating position on non-tariff barriers with Japan for years. It will be better for everyone if they understand we are serious.

Just this January I was in Germany, France and Spain to speak with their economic ministers. They had words of praise for you, Mr. Secretary, for the work you did in the aftermath of the pipeline fiasco. But they also had words of worry. They raised questions about controls on the transfer of technology such as oil and gas equipment. They worried about high American interest rates and what those rates are doing to twist international exchange rates.

It's true that a lot of problems could be softened with an upturn in world economic growth. But that growth isn't in sight. It isn't happening in Latin America. It's barely happening at all in Europe. We can't even be overjoyed about the prospects for solid and substantial growth here at home. I hope, Mr. Secretary, that while you work for economic growth, you have a strategy for dealing with the continuing problems of stagnation--such as the growing debt burden in the third world.

If we are really serious about growing, we've got to resist the urge to adopt reciprocity arrangements or enact domestic content legislation, or build high tariff walls. If we do that, other nations won't be able but what we sell. Once that happens, even more Americans will be out of work.

We did something like that once before. We passed the Smoot-Hawley tariff in 1930 which raised tariffs to unprecedented levels. Foreign nations couldn't afford to trade with us. Our World War I allies couldn't afford to sell products to help pay off their war debts to the United States. History tells us what happened to Europe. The Great Depression is still a harsh reminder of what a restrictive trade policy helped do to us.

I concede that times are rough today. Everywhere we look economic growth in the world is stagnant. Commodity prices are down. Interest rates are up. All those things taken together have cut deeply into the flow of international trade.

So right now, we've got to get busy about doing what's best for the United States. A good place to start is by bringing down American interest rates-- not just with short-term adjustments by the Federal Reserve--but with a durable economic policy that shows we are serious about budget deficits.

I have told every Administration witness to come before this committee that cutting 25 percent of our tax base will guarantee us a structural imbalance that we won't be able to shake with spending cuts. The President's program starts to tackle the deficits. Unfortunately, it does not tackle them until 1986, two and a half years after the beginning of recovery. With deficits so high and for so long, they will act like a magnet on interest rates, tugging them always higher. I'd like to hear your thoughts on the tax cut.

I'd also like to hear what the Administration will do if our allies become so hard-pressed they aren't able to fund arms purchases to defend themselves against a Soviet threat.

And I'd like to have your views on the trade-off that exists in national and western defenses. Are we better off funding an American defense build up at unrestrained levels that add dramatically to our national debt? Or would we be better off with a little more restraint that will keep our deficits lower while adding purchasing power to friendly foreign governments who are willing to buy arms to help defend themselves.

Whether we speak of our own economy, or foreign trade, or allied and American defense, we come up against voices of those who say, "get tough." In a way, they are right. We must be tough enough to see through the clouds and find our best interests.

I think those interests rest with maintaining free trade, with the United States as a free and vigorous competitor. I think those interests rest with an economic policy designed to reduce deficits. And I think those interests rest with a defense policy that says we can't spend our way into national security if, in the process, we undercut the ability of our allies to help.

These are all tough problems. I look forward to your testimony on the choices before us.

Chairman DOMENICI. Mr. Secretary, I failed to mention in terms of legislative requests that appear in our international affairs targets, $2.5 billion increase over the next 5 years for international security assistance, and funds for the conduct of foreign affairs and international information activities. I think that the security assistance increased and the previously mentioned IMF request are the most important numbers that this committee has to deal with. We hope you will share your views on these matters.

You may proceed, Mr. Secretary.

STATEMENT OF HON. GEORGE P. SHULTZ, SECRETARY OF STATE

Secretary SHULTZ. Thank you, Mr. Chairman. I appreciate the opportunity to meet with you.

I have listened to both your opening statements, and I believe I should refrain from trying to comment on them point by point, because they are very perceptive and penetrating, and some are treated in my full statement, which I would like to submit for the record.

Chairman DOMENICI. It will be made a part of the record.[1]

Secretary SHULTZ. I will summarize it more quickly in the breakdown version that I thought I would read here, if that is agreeable with you.

I would make this general comment. I think your perception that to a very considerable degree---

Senator CHILES. I think it would help if you would pull your mike up just a little bit, Mr. Secretary.

Secretary SHULTZ. I share that your perception that to a very considerable degree now we have one economy, a world economy, we have to get ourselves to think that way. Certainly we have one financial system tied together, and to a very considerable extent our economies are tightly intertwined with each other.

ECONOMIC EXPANSION WILL HELP SOLVE PROBLEMS

The second point that I would make is this: the way out of the problems that you enumerated is through economic expansion, here and around the world. And the various programs that are worked out through the IMF, and with our participation and help for individual countries, will work if we have an environment of expansion. If we do not, they have difficulty, so working out these problems depends upon expansion. In that regard we are at a moment in which we have many problems, and if we do not tend to them properly, the problems will get us in deep trouble.

On the other hand, if they are managed right, it seems to me that we may be at a point where we can see that expansion that will help us through the problem. I think the U.S. economy is now starting to expand. I think that the decline in oil prices, which is evident today—you do not have to forecast them, you can observe them—will help the expansion of our economy, of the economy of Japan and of the economies of Western Europe.

So third, I think that we may see a little more expansion there than perhaps was posited. If this financial situation can be kept in gear, this will help the developing world to expand a little more than it did last year, and if we can maintain the openness of our system so these four factors can interplay with each other, then we can see ourselves moving in the way that we want to.

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[1] See p. 556.

Now, there are a lot of ifs connected with that. Important ifs. But nevertheless, with all of the problems, there are some very positive signs and things to work with.

RESTORATION OF GROWTH AND STABILITY IN WORLD ECONOMY

Mr. Chairman, the restoration of growth and stability in the world economy is a fundamental goal of the President's foreign policy. Progress toward that goal supports progress toward our other fundamental goals—safeguarding peace and security and extending the benefits of democracy and freedom.

The growing importance of international economic events in the health of our own economy is a fact of life. The economic fate of nations around the world is now intertwined. No one country can pull up the drawbridge and ignore the rest.

Increased engagement of the United States in the world economy, supports our own growth and makes more complex the task of managing our domestic economy.

Over the last decade U.S. trade has provided a leading edge for U.S. growth. According to one estimate, four out of five new jobs in U.S. manufacturing in the late seventies came from foreign trade. And 40 percent of our agricultural production is now exported. Yet reverses also occur. A crisis in its international finance has forced a draconian retrenchment on one of our major trading partners, Mexico, the third largest trading partner that we have.

If the resulting $10 billion decline over 1982, comparing 1981 with 1982, in the annual rate of its imports from the United States were to be continued, it could entail the loss of one-quarter of a million U.S. jobs—by one estimate. It just shows the interplay here.

A striking feature of the increased U.S. stake in the world economy has been the growing role of developing countries, which now account for nearly 30 percent of U.S. exports.

GLOBAL RECOVERY MEANS JOBS

Global recession has cut U.S. exports and the buoyant contribution they made to U.S. growth in the seventies. And global recovery means jobs and opportunity for U.S. workers and farms. In an interdependent world economy the focus of this committee's labors—excessive U.S. budget deficits—is part of the corrective as well. Although I would put my emphasis, Mr. Chiles, on the out year deficits more than this year's and the 1984 fiscal deficits.

The chain reaction—from persistent U.S. budget deficits for future years to high interest rates, to capital inflows, through the exchange value of the dollar to U.S. exports—is a long, but relentless one.

We must now look at the U.S. position in the world economy as part of our problem of restoring growth without inflation at home.

The world is now coming through a period of painful decompression from the severe inflationary surge of the 1970's. That period has left us with serious problems; high unemployment in the industrial countries; large public sector deficits that constrain recovery; and the heavy debt burden of some developing nations that now strains the international financial system. These problems had their origin in the decade of the 1970's An analysis of that period reveals that they may have a common solution which is, of course, economic expansion in the 1980's.

PAUSE IN GROWTH BROUGHT ON BY GLOBAL RECESSION

Global recession in the past 2 years has brought on an abrupt pause in the growth of developing countries' earnings. The volume of world trade has stagnated and the prices of nonoil commodities have fallen 28 percent from 1980 to 1982, increasing debt service ratios and eroding terms of trade.

The fundamental problem faced by high debt developing countries is one of reviving their exports—an income earning problem, you understand, rather than a debt problem. But, immediately, they confront a financing problem, as banks have precipitously cut back new lending, enforcing draconian cuts in imports. The resulting plight of the high-debt countries has placed the international financial systems under serious strain.

The conclusion drawn from these facts by those who wish to fix blame is that either banks "over-lent" during the 1970's, or countries "over-borrowed."

The truth is that many bad judgments were made. But it is also true that after the oil price increases of 1973-74, lenders and borrowers acted on a set of widely-held assumptions of buoyant export growth and low interest rates—which, though proven false, seemed to be reasonable to many at the time.

The right strategy to overcome the current problems of the world economy is one of sound recovery and growth—without renewed inflation—and underpinned by strengthened international financial and trading systems.

The industrialized countries are now poised to lead an expansion of the world economy. In particular, the United States is on the road to recovery. It appears to me personally that the growth projections in the President's fiscal year 1984 budget will be exceeded. Interest rates are down, inflation is down; inventories are depleted. Basically an expansionary set of policies is in place.

PROGRESS AGAINST INFLATION MADE BY OTHER INDUSTRIAL COUNTRIES

Some other major industrial countries have also made dramatic progress against inflation and have a solid base for recovery. And I believe the recent drop in oil prices will also stimulate expansion.

The north-south linkage works both ways. Renewed growth in the industrial countries will aid the recovery of developing countries. And, the difficult adjustment now being made by several Latin American countries in particular will allow them to resume their role, along with Asian developing countries, as growth poles in the world economy.

The salutary effects of world economic expansion will not come automatically. The United States, together with other nations, must work to insure that the opportunities for growth are seized. Our international efforts should concentrate on three objectives:

first, strengthening an open international trading system, which is under great pressure; second, providing new liquidity and strength to the international financial system, the IMF and the general agreements to borrow problems that you raised; and third, insuring political stability in the developing world.

World trade provided a leading edge of growth for the U.S. and other trading countries in the seventies. It can do the same in the 1980's. Protectionism, however, threatens to restrict trade growth, and thus impede our own recovery and that of our friends.

LARGE SHIFTS IN TRADE ACCOUNTS REQUIRED

A clear example is provided by the high debt developing countries. To earn their way out of their difficulties, which is their objective and ours, these countries require large shifts in their trade accounts. Import cuts can provide only so much; export growth must lead the way in recovery of developing countries. That depends on the United States and other industrial countries, preserving the system of open trade that we helped to build. There is a lot of advice around that tells every country that they should restrict their imports and promote their exports, and everybody cannot do that simultaneously. It is not going to add up. There has to be on expansion that will carry everyone forward.

The recession and high rates of unemployment in the West understandably have increased protectionist pressures. The 98th Congress will probably confront local content legislation, agricultural and other subsidies and a host of protectionist proposals directed at hard-hit sectors such as steel and autos.

The Congress can show its vision by rejecting these protectionist moves which threaten our own recovery and economic expansion generally.

That does not mean, however, that we should acquiesce in other nations' trade-distorting practices—especially those imposed on sectors, such as agriculture and services, in which we enjoy a comparative advantage. Subsidized agricultural exports from the European Communities, for example, have enabled European farmers to expand their share of Third World country markets at the expense of U.S. farmers. In response, we recently sold subsidized wheat flour to Egypt. We thought it might get the Europeans' attention, and it sure did.

We should remember that those measures are not, in themselves, sane actions. Temporary measures tend to become permanent; and retaliation has an inherent tendency to escalate. The United States, the world's largest agricultural exporter, has the most to lose in a spiral of competitive subsidies.

Difficult but important negotiations with the European Communities on agricultural trade subsidies are now in process, and they are not going that well. We will also seek concrete ways of implementing the open trade pledges made by the major industrialized countries at the Versailles summit and the GATT ministerial.

"DEBT BOMB" CAN BE DEFUSED

Turning to the international financial system. The basic approach to deal successfully with recent strains on the international financial system has now been devised. The so-called debt bomb can be defused through emergency short-term bridge financing, stabilization programs implemented in conjunction with the IMF, and continued new financing from commercial banks. Action by all key players is now needed to carry through.

Net new lending by commercial banks to developing countries declined sharply last year from $47 billion in 1981 to somewhere between $20 and $25 billion in 1982. That is a huge decline.

Another abrupt contraction in new lending this year would imperil the recovery of the debtor countries. Mexico and other heavily-indebted countries, all of which have strong trade ties to the United States, have had to cut their imports to the bone. The international economy is too vulnerable to this kind of contraction to permit a continued decline in lending to the Third World.

EXPANSION OF IMF REPRESENTS SOUND INVESTMENT IN GLOBAL RECOVERY

The IMF is a critical part of the fundamental adjustment process. The IMF plays the essential role of helping affected countries develop sound policies of economic stabilization. Such stabilization policies in turn encourage new commercial lending. A Treasury study of IMF programs establishes just this relationship. Over the last 5 years, IMF supported stabilization programs have been followed by new bank lending that is on the average four times greater than the financing provided by the IMF. That is the historical record. The IMF's financing does not pay bank debt, but rather encourages increased bank lending.

The administration is seeking congressional support for the expansion of the IMF's resources needed to enable it to do its essential job. This expansion of the IMF, and the leverage it provides for marshalling other financing, represents a sound investment in global recovery. Action by member countries to implement the quota increases this year is an inherent component of any program to renew world economic growth.

Our share of the IMF quota increase and the related expansion of the general agreements to borrow, totals $8.4 billion. This is the amount that we will be asking Congress to approve before the end of 1983. This is spelled out in a little bit more detail in the full testimony, Mr. Chairman. I will not develop it further.

Even if we succeed in increasing liquidity available to developing countries and preserving relatively open trade, adjustment for many developing countries still will be difficult—in some cases, testing what the social fabric will bear.

Austerity in developing countries can, if excessive, risk political instability that endangers U.S. strategic interests. In this hemisphere, economic difficulties also threaten to increase illegal immigration into the United States.

In short, our own strategic interests dictate the following rule: While adjustment by developing countries is necessary, such adjustment must take place within the limits of the politically possible, and with sufficient financial support to maintain stability and spark renewed growth.

MAJOR THREATS TO INTERNATIONAL STABILITY

Concern for the stability of strategically important developing countries also underlies the administration's foreign assistance request. Again, coming to one of the points you raised. .

Since 1950, most of the major threats to international stability, and the chief opportunities for expansion of the Soviet Union's political reach, have come in the Third World.

The Soviet Union and its allies are able to feed on political instability like viruses on a host. We need the cooperation of countries in the Third World and we must be prepared to help these key countries achieve their aspirations for security and economic growth.

This is the principal purpose of the President's fiscal year 1984 security and development cooperation program. The program focuses on key strategic areas and economic problems which pose short- and long-term threats to the United States.

Our request is for $14.5 billion—4.6 percent more in current dollars than our request last year. So in real dollars, it is about flat. Of this, $4.4 billion is for off-budget repayment guarantees of loans at interest rates which reflect the cost of money to the U.S. Treasury.

Our fiscal year 1984 program also includes critical funds for the multilateral development institutions, particularly for fulfilling our pledge to the International Development Association [IDA], the soft loan window of the World Bank.

COMMISSION TO BE APPOINTED

Mr. Chairman, you have raised a special question about this area, and I know in testifying the other day before the Senate Foreign Relations Committee I got a lot of static about this general area of appropriations. So with the help of many people, it has seemed to me a good idea to appoint a special group to work with you and me on this subject. I think a sound security and development cooperation program is critical to the successful conduct of U.S. foreign policy. I have discussed this extensively with Members of the Congress in recent months, and various members, particularly during our discussions during the special session, suggested to me a bipartisan commission of distinguished Americans, with possible congressional members, at least on a participating basis, to study this program.

I think it is a good idea. So I am going to appoint such a commission to study the program and recommend to the President and the Congress and myself the means required to strengthen it, both in the long-term, and also—by talking to us as we go through this process—immediately.

The former Deputy Secretary of Defense, Ambassador to Portugal, Director of the OEO, the Deputy Director of the Budget and Deputy Secretary of HEW, a very distinguished American, Frank Carlucci, has agreed to chair the commission, and three people have agreed to serve as his cochairmen; Lane Kirkland, president of the AFL-CIO; Clifton Wharton, chancellor of the State University of the New York System, also chairman of the board for International Food and Agricultural Development, and chairman of the

Rockefeller Foundation; and Lawrence Silverman, executive vice president of the Crocker National Bank, former Ambassador to Yugoslavia. There will be additional public members announced shortly, and as I said, we hope to associate with this commission interested Members of the Congress on each committee.

I think it is critical that this be an operating group. We do not need a lot of highfalutin studies. We need people who are part of the action, who understand the political process, as well as the economic and security aspects of this, to help us all reflect on what we are getting out of this program as the United States, and to help conceive a strategy.

So I have extensively consulted with the Congress about this, and I will announce shortly the congressional people who will be associated with this commission. But I regarded that as an important way of addressing one of the questions that you raised.

Chairman DOMENICI. You mean, Mr. Secretary, that they will focus more directly on why is this good for America, is that what you are saying?

Secretary SHULTZ. That is why we appropriate money, and that is why we spend it. We believe that we should do those things in the interest of the United States.

No doubt when we do that, it helps other people as well. Our touchstone has to be what is in the interest of the United States, conceiving of it broadly.

I think you can see by the nature of the people that they are practical, hardheaded, and experienced. I think they will give us a lot of help as they go along, not just in the form of a final report.

This is by way of an announcement. This has not been announced before, and I thought this was a good place to bring it forward, because we do have the chairman, and we have the cochairman all identified, and agreed, and the rest of the commission will be solidified soon.

ECONOMIC EXPANSION IS THE SOLUTION

The relationship between the United States and the international economy is more complex than this general analysis can cover fully. Yet the implications of this brief analysis are straightforward and, I think, valid. The problems currently burdening the international economy—recession, high unemployment, developing country debt—all have a common solution, and that solution is economic expansion.

The industrial countries will have to lead that expansion. The United States is already on the road to recovery. We should be able to look to recovery in some other industrial countries as well. With the approach the administration proposes, and the cooperation of our friends abroad, we have a good chance to avoid international financial upheaval and a fall into a downward spiral of protectionism. If successful in this approach we can look to strengthened international trading and financial systems to speed the benefits of expansion and thus reinforce our own and general recovery.

The United States has a critical role, in cooperation with other countries, in a successful approach to the revival of the world economy and insuring stability of developing countries. This administration has charted a clear course for our own recovery and our contribution to a strengthened international system to sustain general recovery. In successfully following that course we can demonstrate anew the strength of our free society, the vitality of our market economy and the effectiveness of sound international cooperation.

I thank you, Mr. Chairman.

Chairman DOMENICI. Thank you very much, Mr. Secretary.

STATEMENT BY
THE HONORABLE GEORGE P. SHULTZ
BEFORE THE
COMMITTEE ON THE BUDGET
UNITED STATES SENATE

February 22, 1983

Restoring growth and stability in the world economy is a fundamental goal of the President's foreign policy. Progress toward that goal supports progress toward our other fundamental goals -- safeguarding peace and security and extending the benefits of democracy and freedom.

Renewed growth supports the basic strength of our allies and our common defense. The industrial democracies leading the way to global recovery demonstrates once more the vitality of our market-oriented economies and the free political institutions they support. Economic growth in the developing world enables strategically important countries to restore stability and deal with threats to their security.

I would like to address three aspects of the important relationship of the U.S. and the international economy: the increased stake of the U.S. in the world economy, its current problems and challenges for us and the actions the Administration is taking to renew growth in the world economy.

I. The Increased U.S. Stake in the World Economy

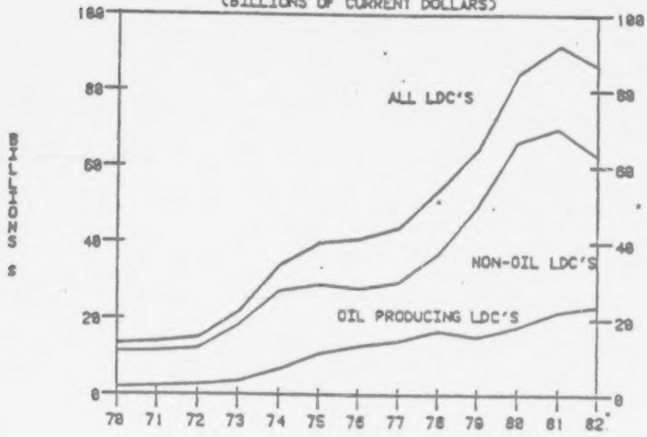
The growing importance of international economic events in the health of our own economy is a fact of life. The economic fate of nations around the world is now intertwined. No one country can pull up the drawbridge and ignore the rest.

Increased engagement of the U.S. in the world economy both supports our own growth and makes more complex the task of managing our domestic economy.

Over the last decade U.S. trade has provided a leading edge for U.S. growth. According to one estimate, four out of five new jobs in U.S. manufacturing in the late 70's came from foreign trade. And 40% of our agricultural production is now exported. Yet reverses also occur. A crisis in its international finance has forced a draconian retrenchment on one of our major trading partners, Mexico. If the resulting $10 billion decline over 1982 in the annual rate of its imports from the U.S. were to be continued, it could entail the loss of a quarter of a million U.S. jobs -- by one, conservative estimate.

The U.S. is now significantly affected by the economic fate of all our major trading partners -- the European Community, Canada, Japan, Mexico and other developing countries. In the last decade exports of U.S. goods as a percent of our GNP have doubled, from 4 percent to over 8 percent. The U.S. economy in turn, representing a quarter of the world product, necessarily has a strong impact on others.

A striking feature of increased U.S. engagement in the world economy has been the growing importance of the developing countries. Since 1975 the developing countries have accounted for more than half the growth in U.S. exports. Developing countries, other than the oil producers, now account for nearly 30 percent of U.S. exports.



U.S. MERCHANDISE EXPORTS TO LDC'S
(BILLIONS OF CURRENT DOLLARS)

* ANNUAL RATE BASED ON 18 MONTHS
SOURCE: IMF

These same countries provide a quarter of the goods we import for use by our industries and consumers.

Net earnings from foreign investment and lending, tourism, insurance and shipping -- the transactions collectively called "services" in our accounts -- have also grown dramatically, from a surplus of just 3 billion dollars in 1970 to 34 billion dollars in 1980. When both trade and services are combined, U.S. corporations derive an estimated one-third of their profits from international transactions.

The U.S. has traditionally been a large investor abroad, and conversely has attracted a great deal of investment. In our international payments these capital flows, positive or negative, react through the exchange rate to offset the balance on trade and services. In recent years, low U.S. savings and high interest rates have attracted foreign capital. This capital inflow has been a mixed blessing. It supplements inadequate domestic savings, but sustains the exchange value of the dollar at a higher level than would pertain if domestic savings were greater -- and the federal budget deficits consumed less of these savings.

Global recession has cut U.S. exports and the buoyant contribution they made to US growth in the 70's. And global recovery means jobs and opportunity for U.S. workers and farms. In an interdependent world economy the focus of this Committee's labors -- excessive U.S. budget deficits -- is part of the corrective as well. The chain reaction -- from persistent U.S. budget deficits for future years to high interest rates, to capital inflows, through the exchange value of the dollar to U.S. exports and imports -- is a long, but relentless one.

In terms of trade, services and finance the links between the U.S. and the world economy have grown strong. We now must look at the U.S. position in the world economy as part of our problem of restoring growth without inflation at home.

II. Current Problems and Opportunities in the International Economy

The world is now coming through a period of painful decompression from the severe inflationary surge of the 1970s. That period has left us with serious problems; high unemployment in the industrial countries; large public sector deficits that constrain recovery; and the heavy debt burden of some developing nations that now strains the international financial system. These problems had their origin in the decade of the 1970s. An analysis of that period reveals that they may have a common solution -- economic expansion in the 1980s.

Recession and high unemployment in the industrial countries came when essential restraining policies collided with stubborn inflationary expectations. After the second oil shock of 1978-1979 the major industrial countries, far from accommodating the increase, adopted restrictive monetary policies which slowed inflation, boosted interest rates, and set in motion a retrenchment from the economic excesses of the 1970s.

High interest rates and a strong dollar increased developing countries' debt service rapidly, while the effects of recession cut their export earnings dramatically. Several heavily-indebted developing countries have thus confronted a financial crisis.

By mid-1982 the foreign debt of developing countries was 500 million dollars -- five times the level of 1973. Of that total roughly $270 million was owed to commercial banks -- more than half of that by three countries, Argentina, Brazil and Mexico.
(See Table 1 and Chart II)

The conclusion drawn from these facts by those who wish to fix blame is that either banks "over-lent" during the 1970s, or countries "over-borrowed."

The truth is that many bad judgments were made. But it is also true that after the oil price increases of 1973-74, lenders and borrowers acted on a set of assumptions--buoyant export growth and low interest rates--that, though proven false, were thought reasonable at the time. The recycling of petrodollars from the OPEC nations to the non-oil LDCs was highly profitable for the banks. And since the loans were in inflation-depressed dollars, the developing countries assumed that today's loans would be repaid with cheaper dollars tomorrow. In this environment, indebtedness mounted.

It would be wrong, however, to characterize the legacy of the oil shock years as a debt problem. Rather, in its broadest aspect, it is an income-earning problem.

True, LDCs borrowed a lot in the 1970s, but our domestic corporations borrow a lot also. The difference is that corporations invest in productive capacity to generate income to repay their debts. Some LDCs, however, tended to invest in consumption rather than production. This strategy, although of questionable wisdom, was tolerable as long as developing countries' export earnings grew fast enough to service their debts. That was indeed the case from 1975 to 1979, when exports of developing countries grew 22 percent annually, roughly keeping pace with the 25 percent annual growth of their debt.

Global recession in the past two years has brought on an abrupt pause in the growth of developing countries' earnings. The volume of world trade has stagnated and the prices of non-oil commodities have fallen 28% from 1980 to 1982, increasing debt service ratios and eroding terms of trade. The fundamental problem faced by high-debt developing countries is one of reviving their exports -- an income earning problem, rather than a debt problem. But, immediately, they confront a financing problem, as banks have precipitously cut back new lending enforcing draconian cuts in imports. The resulting plight of the high-debt countries has placed the international financial system under serious strain.

Recession and stagnation of world trade have also created strong strains on the world trading system. Pressures for protectionist trade measures exist in many countries, but a general struggle for increased shares of a static world trade pie offers little hope to anyone.

III. The Response of the Administration

The right strategy to overcome the current problems of the world economy is one of sound recovery and growth -- without renewed inflation -- and underpinned by strengthened international financial and trading systems.

The only lasting solution to the econonic problems of the industrial countries and the income-earning problem of the developing countries is sustained economic growth. The response to the pressures on the world trading and financial systems is expanding opportunities.

A. The Opportunity for Growth

The industrialized countries are now poised to lead an expansion of the world economy. In particular, the United States is on the road to recovery. It appears to me personally that the growth projections in the President's FY 1984 budget will be exceeded. Interest rates are down; inflation is down; inventories are depleted. Basically an expansionary set of policies is in place.

Some other major industrial countries have also made dramatic progress against inflation and have a solid base for recovery. Japan already grew moderately last year, with only a 3% increase in consumer prices. Germany's inflation was down to just over 5% last year. The U.K. also achieved a significant cut in its inflation rate last year (from 11.8 percent in 1981 to 8.7% in 1982 in terms of consumer prices).

In short, the United States and other industrialized nations that have reduced inflation are positioned to play a vital role in world economic expansion.

The recent drop in oil prices may also stimulate expansion. Of course, an oil price decline is not unambiguously good, for any sudden, unanticipated change in the world economy causes disruptions. An oil price decline may, for example, harm individual countries--especially developing countries such as Mexico and Venezuela which export oil.

But assume for the sake of illustration (as distinct from prediction) a decline to, say, $20 a barrel (a 40 percent drop). It has been estimated that such a price decline would, in the aggregate, have the following catalytic impact over a two year period: real growth rates in industrial countries would increase 1 to 1-1/2 percent; the 1983 oil import bill for industrial countries would drop by $90 billion, and that for LDCs by $9 billion; the OECD current account balance would swing from a deficit of $18 billion to a surplus of $17 billion; simultaneously, LDC exports would rise 3 percent, cutting their current account deficit by $18 billion. A less significant oil price decline would have similar positive effects, roughly proportional to the reduction from current prices.

Renewed growth in the industrial countries will aid the recovery of developing countries. It has been estimated that if the GNP of the industrial countries of the OECD were to grow by 4 percent in 1983 rather than the projected 1.8 percent, the non-oil developing countries would earn an additional $15 billion from their exports.

The north-south linkage works both ways. Indeed, the eventual result of the difficult adjustment now being made in several Latin American countries in particular should be that they resume their role, along with Asian developing countries, as growth poles in the world economy.

The salutary effects of world economic expansion will not come automatically. The United States, together with other nations, must work to ensure that the opportunities for growth are seized. Our international efforts should concentrate on three objectives: first, strengthening an open international trading system, so that world trade can be an engine of growth for all countries in the 80's; second, providing new liquidity and strength to the international financial system, so that incipient recovery is not aborted by international financial strains; and third, ensuring political stability in the developing world.

Working toward each of these objectives entails cooperation between business and government, between the US and other industrial countries, between the developed and developing world, and between the Executive Branch and the Congress.

B. Strengthening the International Trading System

World trade provided a leading edge of growth for the U.S. and other trading countries in the 70's. It can do the same in the 1980's. Protectionism, however, threatens to restrict trade growth, and thus impede our own recovery and that of our friends.

A clear example is provided by the developing heavily-indebted countries. To earn their way out of their difficulties, which is their objective and ours, these countries require large shifts in their trade accounts. Import cuts can provide only so much; export growth must lead the way in recovery of developing countries. That depends on the U.S. and other industrial countries' preserving the system of open trade we helped build.

The recession and high rates of unemployment in the West understandably have increased protectionist pressures. The 98th Congress will probably confront local content legislation, agricultural and other subsidies and a host of protectionist proposals directed at hard-hit sectors such as steel and autos.

The Congress can show its vision by rejecting these protectionist moves which threaten our own recovery and economic expansion generally. Quotas, tariffs and other trade barriers raise costs to us and deny borrowing countries the hard currency earnings needed to service their debts and buy our exports. Conversely, open trade speeds resources to their most productive uses and creates more jobs than it destroys.

That does not mean, however, that we should acquiesce in other nations' trade-distorting practices--especially those imposed on sectors, such as agriculture and services, in which we enjoy a comparative advantage. Subsidized agricultural exports from the EC, for example, have enabled European farmers to expand their share of third country markets at the expense of U.S. farmers. In response, we recently sold subsidized wheat flour to Egypt.

Temporary, trade-distorting measures such as the wheat flour transaction can be justified on the ground that "when all the world is mad, 'tis folly to be sane'." But we should remember that those measures are not, in themselves, sane actions. Temporary measures tend to become permanent; and retaliation has an inherent tendency to escalate. The U.S., the world's largest agricultural exporter, has the most to lose in a spiral of competitive subsidies. Constructive negotiations -- in which we meet unreason with reason -- present the only lasting solution to protectionist problems such as export subsidies.

We will, therefore, work within the GATT to remove barriers to the export of U.S. services and agricultural products. In addition, we will work on a bilateral basis, as I did on my trip to Japan, to roll back trade barriers. Difficult but important negotiations with the EC on agricultural trade subsidies are now in process. Finally, we will seek concrete ways of implementing the open trade pledges made by the major industrialized countries at the Versailles Summit and the GATT Ministerial.

C. Strengthening the International Financial System

The basic approach to deal successfully with recent strains on the international financial system has now been devised. The so-called "debt bomb" can be defused through emergency short-term bridge financing, stabilization programs implemented in conjunction with the IMF, and continued new financing from commercial banks. Action by all key players is now needed to carry through.

Net new lending by commercial banks to developing countries declined sharply last year, from 47 billion dollars in 1981 to somewhere between 20 and 25 billion dollars in 1982.

Another abrupt contraction in new lending this year would imperil the recovery of the debtor countries. Moreover, reduced lending, in the face of increased debt service costs, would retard our own recovery by contracting imports by developing countries. Indeed, as Rimmer de Vries recently testified, a Morgan Guaranty Trust Company study estimates that if capital flows into developing countries were cut by $25 billion, OECD growth would drop at least half a percentage point. With OECD growth in 1983 expected to be only 1.8 percent, half of a percentage point would represent a significant cut in growth.

The Morgan Guaranty study is hypothetical. But import cuts are already a reality. I have cited the dramatic case of Mexico, whose imports from the U.S. dropped 60% from the first quarter of 1981 to the last quarter of 1982. The drastic cut in Mexico's imports, if sustained, would represent a 10 billion loss in U.S. exports and the elimination of at least 250,000 American jobs. Other heavily-indebted countries, all of which have strong trade ties to the U.S., have had to cut their imports to the bone as well.

The international economy is too vulnerable to this kind of contraction to permit a continued decline in lending to the Third World. Private banks have a collective interest in extending sufficient new money to permit the developing countries to service their debts. Western governments, including our own, have a similar stake in seeing that the developing countries have sufficient capital to pay for imports of goods and services that will enhance their productivity, and contribute to world economic expansion.

The United States has provided, as in the case of Mexico, temporary bridge financing. But this is only short-term relief.

The IMF is a critical part of the fundamental adjustment process. The IMF plays the essential role of helping affected countries develop sound policies of economic stabilization. Such stabilization policies in turn encourage new commercial lending. A Treasury study of IMF programs establishes just this relationship. Over the last 5 years, IMF supported-stabilization programs have been followed by new bank lending that is on average four times greater than the financing provided by the IMF. The IMF's financing does not pay bank debt, but rather encourages increased bank lending.

The Administration is seeking Congressional support for the expansion of the IMF's resources needed to enable it to do its essential job. This expansion of the IMF, and the leverage it provides for marshalling other financing, represents a sound investment in global recovery.

In negotiations just concluded member countries of the IMF agreed upon a quota increase of 47 percent from 67 billion dollars to 99 billion dollars (at the current SDR/dollar rate). The proposed increase in the U.S. quota is $5.8 billion, representing 18% of the total increase. Action by member countries to implement the quota increase this year is an inherent component of any program to renew world economic growth.

Another component of such a program is the expansion of the General Arrangements to Borrow. The GAB was initially established by ten industrialized nations as a back-up line of credit to be drawn upon solely by the ten contributing countries. However, late last month in Paris, the United States, together with the other nations of the Group of Ten, agreed to increase the GAB from $7 billion to $19 billion. Our share of this expansion is $2.6 billion. Unlike the traditional GAB, access to this expanded fund will not be limited to the G-10 alone, but will be accessible to any country whose liquidity problems threaten the financial system as a whole.

Our share of the IMF quota increase and the GAB expansion totals $8.4 billion. This is the amount we will be asking Congress to approve before the end of 1983.

D. Ensuring Political Stability

Even if we succeed in increasing liquidity available to developing countries and preserving relatively open trade, adjustment for many developing countries still will be difficult--in some cases, testing what the social fabric will bear. Developing countries have had to accommodate the recession in the industrial countries and their own financial problems by cutting imports and curbing economic growth. Aggregate real growth of non-oil developing countries this year will be about 1 percent -- the lowest since 1950.

Austerity in developing countries can, if excessive, risk political instability that endangers U.S. strategic interests. In this hemisphere, economic difficulties threaten to increase illegal immigration into the United States. Economic troubles were a factor in the recent expulsion of hundreds of thousands of Ghanaians from Nigeria. And economic difficulties in the Sudan could, for example, threaten the U.S. interest in Middle East stability.

In short, our own strategic interests dictate the following rule: while adjustment by developing countries is necessary, such adjustment must take place within the limits of the politically possible, and with sufficient financial support to maintain stability and spark renewed growth.

Concern for the stability of strategically important developing countries also underlies the Administration's foreign assistance request.

Since 1950, most of the major threats to international stability, and the chief opportunities for expansion of the Soviet Union's political reach, have come in the Third World. As you know, some 1,200 marines are currently on duty in Lebanon helping prevent renewed fighting there.

The Soviet Union and its allies are able to feed on political instability like viruses on a host. Some of most significant uses by the Soviets of military power since World War II have been in the developing world. The Soviet deployment of a deepwater navy, an airlift capacity, and mobile ground forces have given them the ability to intervene quickly when they perceive targets of opportunity. We cannot ignore this reality as it challenges our national interests.

The job of containing the political influence and military reach of the Soviet Union also requires that we maintain military facilities and strengthen indigenous defense forces around the world. The U.S. cannot defend its interests by operating out of the US and Europe alone. We need the cooperation of countries in the Third World and we must be prepared to help these key countries achieve their aspirations for security and economic growth.

This is the principal purpose of the President's FY 1984 Security and Development Cooperation Program. The program focuses on key strategic areas and economic problems which pose short- and long-term threats to the United States.

Our request is for $14.5 billion -- 4.6 percent more in current dollars than our request last year. Of this $4.4 billion is for off-budget repayment guarantees of loans at interest rates which reflect the cost of money to the U.S. Treasury.

As the figures below show, about 63 percent of our request is for security assistance: military aid and economic support funds (ESF) to assist in building the economic and military capabilities of countries and regions of strategic importance. Thirty-seven percent of the total program is for worldwide economic assistance through both bilateral and multilateral programs. Reading across the table, if you add the ESF -- that is the funds used for economic growth in the key security countries -- to the worldwide economic assistance, then the program divides functionally as 53 percent of the funds used to spur economic growth, 43 percent for military aid, and 4 percent for refugee assistance and other uses.

FUNDS ARE USED FOR	SECURITY ASSISTANCE PROGRAM	ECONOMIC ASSISTANCE PROGRAM	TOTAL
		($ Billions)	
Military Aid	$ 6.2		$ 6.2 (43%)
Economic Growth	$ 2.9	$ 4.8	$ 7.7 (53%)
Other*	$ 0.1	$ 0.5	$ 0/6 (4%)
Totals	$9.2 (63%)	$5.3 (37%)	$14.5 (100%)

* Other includes refugee assistance, Peace Corps, Narcotics Control, and other small programs. Percentages are rounded off.

Our FY 1984 program also includes critical funds for the multilateral development institutions, particularly for fulfilling our pledge to the International Development Association (IDA), the soft loan window of the World Bank. Our commitment to share in IDA's worldwide program -- a program which we reviewed carefully in 1981 and found to be effective -- has been reaffirmed by the President at the recent meetings of world leaders in Cancun and Versailles

IV. Implications

The relationship between the U.S. and the international economy is more complex than this general analysis can cover fully. Yet the implications of this brief analysis are straightforward and, I think, valid. The problems currently burdening the international economy -- recession, high unemployment, developing country debt -- all have a common solution: economic expansion.

The industrial countries will have to lead that expansion. The U.S. is already on the road to recovery. We should be able to look to recovery in some other industrial countries as well. With the approach the Administration proposes and the cooperation of our friends abroad we have a good chance to avoid international financial upheaval and a fall into a downward spiral of protectionism. If successful in this approach we can look to strengthened international trading and financial systems to speed the benefits of expansion and thus reinforce our own and general recovery.

The requested investments in international financial stability and foreign assistance are not small - but they are moderate in light of the benefits to our own economy and security. They contribute to the strength of strategically important countries and the stability of developing countries generally.

The U.S. has a critical role, in cooperation with other countries, in a successful approach to revival of the world economy and ensuring stability of developing countries. This Administration has charted a clear course for our own recovery and our contribution to a strengthened international system to sustain general recovery. In successfully following that course we can demonstrate anew the strength of our free society, the vitality of our market economy and the effectiveness of sound international cooperation.

TABLE I

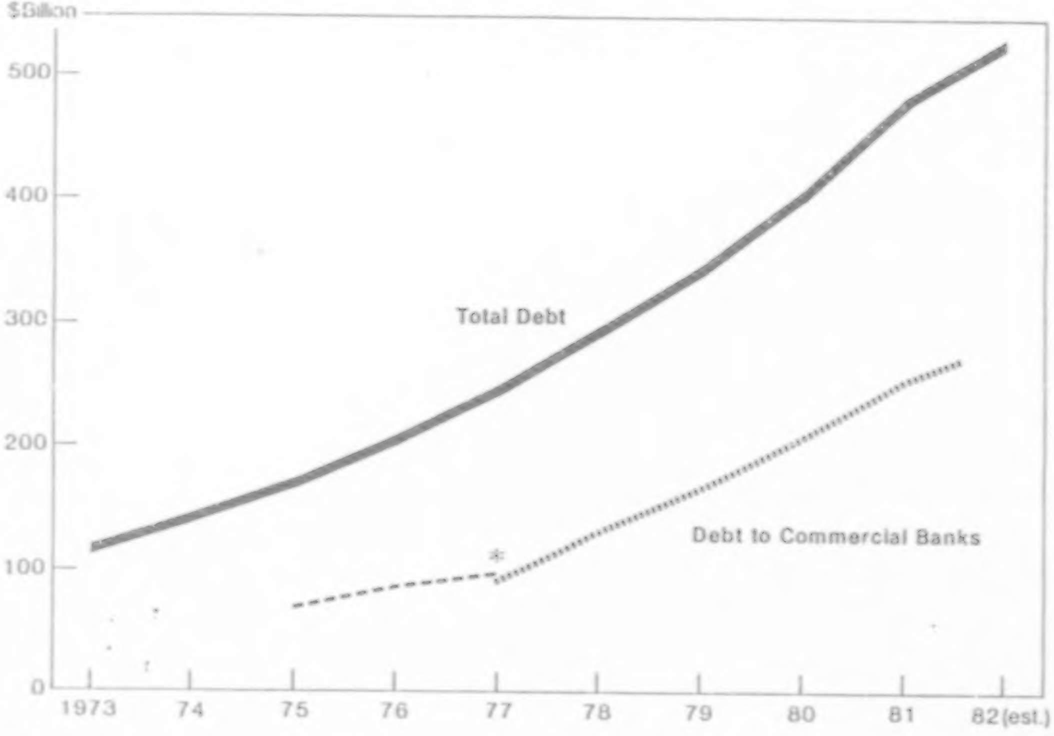
U.S. and Non-U.S. Bank Claims on Major Borrowers, June 1982
(billions of dollars)

Country	Total	U.S.	Non-U.S.	U.S. % share
1. Mexico	64.4	24.3	40.1	37.7
2. Brazil	55.3	20.7	34.6	37.4
3. Venezuela	27.2	11.1	16.1	40.8
4. South Korea	20.0	8.7	11.3	43.5
5. Argentina	25.3	8.6	16.7	34.0
6. Chile	11.8	6.3	5.5	53.4
7. Spain	23.7	5.7	18.0	24.1
8. Philippines	11.4	4.8	6.6	42.1
9. Taiwan	6.4	4.4	2.0	68.8
10. Colombia	5.5	2.7	2.8	49.1
11. Greece	9.7	2.7	7.0	27.8
12. Yugoslavia	10.0	2.5	7.5	25.0

Source: (1) BIS semi-annual maturity survey; (2) U.S. Country Exposure Lending Survey (data adjusted to a BIS basis).

CHART 11.

OUTSTANDING FOREIGN DEBT OF OIL-IMPORTING LDCs



* Series break.

U.S. Treasury Dept.
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Chairman **Domenici**. Personally, Mr. Secretary, I think you hit the nail right on the head in your announcement today. I did not know that you were going to make that announcement, but in my few moments with you before this hearing, we discussed the problem of public support.

It is very difficult in these times of restrained budget for many of us to understand why we have to increase the American commitment to the programs you have discussed. I do not think it is just me, and some of us who are elected to represent Americans. I think the American people have a difficult time understanding foreign aid and other international spending.

As usual, you have come up with a very pragmatic solution. Your commission will bring us together with some people that are not in the government like us, but who also have America's interest at stake. A commission on security and economic assistance can begin to explore and advise and help with the educational process, which I think is absolutely necessary.

I am not going to ask questions at this time. I am going to yield to the distinguished—to Senator Kasten, and he can take my time because he must leave. Frankly, Senator Kasten has two roles which he serves here, but he is the chairman of the Appropriations Subcommittee that will have the very difficult job of fitting these foreign aid programs into an appropriations bill. Senator, I yield to you my time at this point.

Senator **Kasten**. Mr. Chairman, thank you very much. I also thank you, Nancy, for allowing me to go ahead of you.

CONTROVERSY OVER REQUEST FOR INTERNATIONAL MONETARY FUND

Mr. Secretary, the most controversial item in the foreign assistance area is the budget authority request for the International Monetary Fund. The IMF increase breaks down to $5.8 billion for the quota increase and $2.7 billion for the general agreements to borrow.

The Banking Committee and the Senate Foreign Relations Committee are having hearings on the issue right now, but at one point we are going to get down to the appropriations process.

First, Paul Volcker from time to time discussed taking the IMF off-budget. All of us are interested in nailing down the administration's position on that question. The IMF request will soon be sent up here. Will it be sent up here fully subject to an appropriation of budget authority?

Secretary **Shultz**. Well, it has to be approved by the Congress so there has to be authority to take this step. There is no other way.

Now, technically what happens when the IMF quota is increased is that the United States exchanges one asset for another asset. So, in a sense, it is not like other spending but it is something that needs to be looked at by the Congress and authorized by the Congress, obviously.

Senator **Kasten**. So, it would be subject to an appropriation of budget authority, and you are not trying to work around that process?

Secretary **Shultz**. There is no way that this can happen without the Congress saying OK.

IMF INCREASE MUST BECOME AVAILABLE SOON

Senator KASTEN. Second, a consensus is developing up here that it might be wiser for the administration to send up the IMF request as an 1983 supplemental, rather than by including it in the 1984 appropriations, or the—in the 1984 budget.

Now, it is in our 1984 base line. I think this idea has merit, especially considering that the added controversy and difficulties that we have had in foreign aid, in general, which you and the chairman have spoken about.

In other words, that we would be treating the IMF request separate and apart from the other problems that we have in foreign assistance.

What are your thoughts on this suggestion?

Secretary SHULTZ. Well, I—my instinct is like yours, to favor that. I cannot say that I am close enough to exactly what the right congressional process on this is, to make a flat recommendation here.

I think the basic point is this. To be effective, this increase has to become available reasonably soon.

Senator KASTEN. The IMF increase?

Secretary SHULTZ. Yes, sir, and, of course, all around the world people are watching because they know that, for example, we have made commitments, the IDA commitments that I spoke about here were made during the Carter administration, and we are trying to deliver on that commitment, and we have not.

So everybody says, well, the United States has sat at meetings, and the Secretary of the Treasury, with the authority of the President, has agreed to this, but will you really come through, and what they do depends on what we do. So the sooner we address this, and make our decision, as a Government, congressional and executive, the better.

SEPARATE IDA DECISIONS FROM IMF DECISIONS

Senator KASTEN. Well, I think it is important that we separate the IDA decisions from the IMF decisions, as well.

Secretary SHULTZ. Oh, yes, those are different questions.

Senator KASTEN. The best way to do that is to consider the IMF decision as a 1983 supplemental and the IDA decision as part of the 1984 budget process. That group of Commissioners is going to have to be awfully good to get an $85 million increase—from $700 million to $1 billion—and I do not think they are going to do it.

I do not think you have the kind of congressional support necessary to support the soft loan window of foreign aid.

But on the IMF, you have a different set of circumstances, and a different set of restraints, and possibly we can do it.

What——

Secretary SHULTZ. I might just take note of the fact, I recognize the difficulty in the case of IDA. I think there have been some important things done under the leadership of the President and Secretary Regan, that I think can give people a little more comfort there. We have put an amount in a supplemental for 1983, designed to bring the total back up to the President's original request.

So you will be getting that, and I know you will be glad to have it in that supplemental.

Senator **Kasten**. $245 million is going to be tough, as well.

Just one last question.

ASSURANCE WANTED THAT PROBLEMS ARE OVER

In the IMF negotiations, you and others in the administration have worked hard to keep the quota increase and GAB as low as possible.

How can you assure us that you are not going to be coming here again a year from now, or maybe even later this year, to ask for another quota increase? Or for some kind of special bilateral aid to one of the countries that might be in trouble, particularly Mexico?

In other words, is there a way that you can assure this committee, as a budget group, that your IMF request of $8.5 billion will be enough, or are we going to just keep dribbling away at the IMF through quota increase over quota increase?

Secretary **Shultz**. Well, sir, I believe that if we handle things correctly, we will see the emergence of expansion in the world economy, and if we get that, then these problems will be put into a different perspective, and all of this will work, that is what I think will happen, and the IMF quota increase will play a strategic part in bringing that about.

I cannot give you a 100-percent guarantee that what I say is going to happen will happen. And therefore, I cannot make a flat statement.

My best judgment is that this will work. But maybe it will not.

Senator **Kasten**. There are a number of people that are not as optimistic as you are.

Secretary **Shultz**. That is true, that is why I say that——

Senator **Kasten**. I appreciate your candor, and honesty.

Thank you, Mr. Chairman.

DIFFICULTIES CREATED BY OIL PRICE DECLINE

Secretary **Shultz**. I would say this. I think this decline in oil prices is in some ways, the big economic story of the year, not so much because of the decline in the prices, but the implications. The implications, as I said, are broadly positive, although it is going to create some great difficulties for some countries and for some U.S. institutions. I think it will behoove us to look with a reasonable eye on those difficulties, and to try to be helpful in them, because they will be quite severe if the price should drop by a lot.

Chairman **Domenici**. Thank you, Senator.

Senator Chiles?

Senator **Chiles**. Mr. Chairman, I am going to yield to Senator Exon, who was here first.

I do want to say, Mr. Secretary, that I am delighted to hear of the commission you have appointed, and of its purpose. I think that is something that is very, very strongly needed in this country. Some of us on our side of the aisle, I guess, had to view that a little bit with some amusement; some of the happenings when our brethren became the majority, and for the first time some voted for foreign aid who had voted against it for all the period of time that they have been in the Senate.

It seems that over the years the Democrats have generally had to carry that political burden, and it certainly has been a political burden, because this is probably the most popular of all appropriations that we make, and part of that has been that it was used as a political football.

Thank goodness we are getting away from that now, and beginning to see what is in the best interest of this country, and that is exactly where the decision should be, and I am delighted to see that you are taking a lead in appointing this commission, because I think they could be very, very helpful.

Secretary SHULTZ. I do not begrudge you your amusement, Senator, but I hope you stay on board. That is the big thing.

Senator BOSCHWITZ. We finally figured out how to become a majority.

Chairman DOMENICI. Senator Exon?

Senator EXON. Thank you, Mr. Chairman.

Mr. Secretary, welcome, and thank you for coming.

Certainly, agriculture is a key part of our international trade, and you have alluded to it in your statement, and I thought your statement was a good one. We have felt for a long time that your Department, and this goes back before you were there, has been one of the problems that we have had with exports in agriculture, due to the fact that we in the agricultural sector generally feel that the State Department has used and abused agriculture through a whole series of administrations.

Do you generally agree with that, and if you do, what have you done to correct that image?

OPEN MARKETS TO OUR AGRICULTURE COMMODITIES

Secretary SHULTZ. Well, I cannot speak about all of the history. I think that trade in our agricultural products is very important to us. It is an area where we have a comparative advantage. We are very good at it, and so it is the kind of commodity that we should be able to sell competitively on the world market. So, we want to have markets open to our agricultural commodities, and I support that in every way I possibly can.

Now, I also recognize that there have been times when trade has—not only agricultural trade, but other trades as well, has been used as a tool in the conduct of foreign policy, and that often puts you at odds with the industrial sector, or agricultural sector involved.

I think that should be something done as a last resort. I do not say it should never happen, because there can be circumstances, I think, where things would happen where you would not want to trade, and you would not want to lend that support to another country.

But it seems to me on the whole it should be a last resort and that we have to be careful that we do not so conduct ourselves that we appear to others like an unreliable source of supply, because once people get the idea that we may be here today and gone tomorrow, they look for other places to get their supplies.

So, I think that is a matter to be extremely cautious about.

LONG-TERM GRAIN AGREEMENT NO NEARER

Senator **Exon**. Well, Mr. Secretary, I would agree with you completely. That leads me into something more specific.

In the last Presidential campaign, the President made quite a thing about the embargo that had been placed by the previous administration on the sale of grain to the Soviet Union, but it seems to me that basically since then we have had a de facto embargo, because this administration has absolutely refused even to go into discussions with the Soviet Union with regard to a long-term grain agreement.

Have you done anything in your capacity—I recognize you are fairly new in your position—have you done anything at all to nudge the President toward a more realistic approach to a long-term grain agreement with the Soviet Union?

Secretary **Shultz**. Well, I do not think the President needs any nudging from me, but I would say this, that the relationship of the United States to the Soviet Union is a relationship of tremendous importance, and I recognize that in the job I have, it is up to me to help the President manage that relationship to our very best advantage. It is a relationship that has tremendous tension and strain in it, for a wide variety of reasons, prominently, the tremendous arms buildup in the Soviet Union, their use of those arms, their behavior in Third World countries, their treatment of people, and in many other respects.

So, we have to manage this relationship in a reasonable way. Whether it can be a more constructive relationship or not, remains to be seen.

The President has had in place, and has in place today, a policy that says they have to be realistic about what they are doing; that we have to be strong ourselves, economically, militarily, and in our willpower; and that we also have to be willing to solve problems, and negotiate and work things out.

With the new leadership in the Soviet Union, the President has sought to underline a third point. But we have to see what may emerge from that.

At this point, there is nothing there that I can talk about, but it is being worked on, and certainly economic relationships are a part of that equation. But they are only a part of it. So, this is kind of a long-winded nonanswer.

The grain agreement has to be a part of this process, in and of itself. I, personally, think it is a good idea.

Senator **Exon**. What is a good idea?

Secretary **Shultz**. If we are going to have trade with the Soviet Union, of a long-term nature in this field, then having some understanding of a long-term nature about how it is conducted is a good idea. But I think the manner of our trade with the Soviet Union is something that is related to the way this overall relationship emerges.

Senator **Exon**. I take it from your answer that we are no closer to a long-term grain agreement, or to begin talks with the Soviets about such an agreement than we were say 6 months ago, is that a fair assumption?

Secretary SHULTZ. That is a fair assumption.

Senator EXON. One more short statement, and then a question, Mr. Chairman, and I then will yield.

Secretary SHULTZ. But I do not say, Senator, that this relationship cannot find constructive things to do, but we have to be thinking about it as a whole, because in many respects the peace and security of the world hangs on this relationship, that we must be careful about it.

SEND MESSAGE LOUD AND CLEAR ON TRADE POLICIES

Senator EXON. Mr. Chairman, the other question I have with the Secretary is in regard to our trade policies around the world.

You stated many of your objectives very well in your prepared statement, Mr. Secretary, and I generally agree with what you have had to say.

With regard to the assistance that we are going to give to the international monetary system that you have outlined is very shaky, to some degree, I think that depends on how tough we are going to get under the leadership of the State Department with regard to predatory practices that are being used against us in many of our supposed friends and trading partners.

Certainly today in agriculture, when we have instituted a program where we are trying to take about half of our land out of production, we see governments in Japan, and in the European Common Market subsidizing their farmers to the place where we cannot begin to compete.

It seems to me that we should send a message, loud and clear, and I say that as one that has not yet voted for any of the restrictive trade policies. I am a free trader by nature. But I must tell you in all sincerity that the agricultural sector is being hurt, and hurt badly today, from lots of reasons, not the least of which, in my opinion, is the fact that we are not being properly considered by our trading partners around the world.

Certainly, if there is one place, if we get into an all out trading war, we are going to win. We might not win in automobiles, we might not win in steel, and we might not win in other places, but on a strictly free trade, free enterprise system, I am certain that because of the genius of production and the land, the country in which we are privileged to live, that we can indeed prevail if we get into an all out trade war with regard to food production. That message should be sent to our trading partners around the world, and I am wondering if they fully understand it, and I am wondering how clearly the State Department has told them how we feel about some of the practices that are presently in place.

ALL OUT TRADE WAR WOULD HAVE NO VICTOR

Secretary SHULTZ. Well, as I mentioned in my testimony, we have been in discussions with the European Community about their subsidy programs, and have tried to make it clear to them that we are serious about taking the steps that may be necessary to defend the interests of our farmers.

Having said that, Senator, I would have to disagree with you about our ability to prevail in a trade war. I do not think there will be any big victor in an all out trade war. I think that if that happens in this world, and spreads around so that what happens is that every country sort of goes in, that what we will have is a contribution to a very bad international economic situation, not a good one, and it will not do us much good to feel that, well, we beat them down.

Let me just take an example. You mentioned Japan with a certain zip from your point. The largest customer the American farmer has abroad is Japan. I know we have some big arguments with them in the field of beef and citrus. I believe it is the case that 60 percent of the beef exported from the United States goes to Japan. So it is not all bad.

In the field of citrus, I think it is mainly oranges. Now, having said this, I do not mean to take the heat off that discussion at all. But what is the volume of agricultural exports to Japan? I think it is over 6 billion dollars' worth.

Senator **Boschwitz**. $6.7.

Secretary **Schultz**. $6.7, thank you, Senator.

So if we say, all right, we beat them down on oranges and beef, and we throw away that kind of a trade, I do not think that is any——

Senator **Exon**. Well, I am not suggesting that we throw away that trade. I am just saying are we getting our fair share on the world, Mr. Secretary?

I thank you, and I thank you, Mr. Chairman.

Chairman **Domenici**. Thank you very much, Senator.

Senator Kassebaum?

Senator **Kassebaum**. Thank you, Mr. Chairman.

Certainly, Mr. Secretary, you are most thoughtful, and as the Chairman said, pragmatic spokesman for our foreign policy.

There are a couple of questions that, in trying to analyze the budget, foreign aid requests that I would like to ask.

JUSTIFYING INCREASE FOR SECURITY ASSISTANCE

One is that the administration is requesting a $1.5 billion increase for security assistance over last year's figures. This is a sizable increase, particularly in the light of the rest of the foreign aid increase, and I would like your thoughts on what world events you feel justify this increase, particularly in light of the fact that it is the economic problems we are struggling with, and also the fact that we are attempting to get our own budget deficits under control, and that that as a matter of fact reacts on international stability as well.

Secretary **Shultz**. We have worked very hard on both the security and economic assistance program, to make them dovetail with each other, so that our security and economic assistance move together.

Do you have the longer testimony there?

Senator **Kassebaum**. Yes.

Secretary **Shultz**. If you look at my prepared statement,[1] there is a little table that I think is instructive on the kind of the internal character of this program. And you can see by that table, that if you break the economic and the military side of the security assistance program out, and then you combine that with the economic assistance program, you wind up with the percentages that are shown on the table on the right-hand column.

About all I can say is that we think the mixture is right, and we believe that in many countries, we must give support to the military capacity of that country to defend itself, and that such a defense is a necessary ingredient to economic growth and development.

At the same time, as you know, the security assistance program is an assistance to us. So that things that we do in other countries provide landing rights, basing rights, port facilities, and so forth, to enable us to support and defend the interests of the United States around the world, and our interests are obviously very extensive.

So it is that general kind of consideration that led to this budget. It is one that has been honed down. The people who administer these programs, I can assure you, as I suppose they should, wanted a lot more, but this has been shaved down, and we think it is essential.

Senator **Kassebaum**. Certainly, Mr. Secretary, I would say that a number of countries request this type of assistance. I do not want to be misleading, because I have heard the charge made that we are trying to enhance strategic assistance to the detriment of economic assistance, and that is not the case as far as requests from other nations.

But I do believe when we are trying to analyze, in light of our own budget priorities, that while I certainly understand the side of the argument you make, and I think it is an important one, it is a question that in just judging whether that money is being used in a successful and effective way.

EARMARKING FUNDS

One of the problems that we have stemming from a Foreign Relations Committee viewpoint is, I think, a question of earmarking funds, and this leads to my second question that they are really tied together, because the largest in 1983, we increased grant aid to the largest two countries who have received U.S. foreign aid, Egypt and Israel.

And at the time of the continuing resolution, then we lowered overall foreign aid levels, and I would like to ask you if there is a problem, the earmarking problem, which then has caused problems for other countries to try and adjust to the increase received by the two earmarked countries for the $1 billion supplemental that the administration has requested.

Should we earmark everything, or should we earmark nothing, or is this a combination of lowered levels, and increased earmarks led to this particular supplemental request?

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[1] See p. 575.

Secretary SHULTZ. That is exactly what led to the supplemental request. A number of important components of our program in particular countries very important to us, got squeezed down, or out.

I stood, a couple of weeks ago, on the DMZ line in Korea, and there you really feel that you are on the front lines; there is no doubt about it. We are working with a country that is spending over 6 percent of its GNP on its own defense. We have our forces there, and our FMS was cut down by $70 million. We have got to do our part in a place like that.

And the same comment could be made around the world, and that is what is going into this supplemental. So I say, without commenting one way or the other, on any particular increase in earmark, and the request that you mentioned were not the only ones that were increased in earmark, that that process is one which allows people to focus on some particular things that they like, but does not, I think, give the sort of balanced view that we have to have in conducting a world policy.

Senator KASSEBAUM. Should we do away with all earmarking?

Secretary SHULTZ. Well, not necessarily. I think that after all, we in the executive branch try to do what the Congress in its appropriations tell us to do, and you have to be the arbitrator of that. But it seems to me that we need to have a world view of the matter, so that we do not wind up unable to do our job and carry out our commitments in parts of the world that do not have to be on the front burner at a particular time.

Senator KASSEBAUM. Thank you.

Chairman DOMENICI. Senator Johnston?

BAIL THE BANKS IN, NOT OUT

Senator JOHNSTON. Mr. Secretary, I recognize the point made in your statement, that we cannot let the international economic house of cards come down, and that the IMF is probably the best means of preventing that.

But my question is, and the question of a lot of people back home, and of a lot of people in the Congress is, are we going to bail out the banks, without having them put up any of their capital?

Are we simply going to underwrite what were probably imprudent loans, or are we going to, as Felix Rohatyn suggested in an article I read last night, require the banks, for example, to lengthen their loans, and lower the interest rates on them, to say 20-year loans and 5 percent interest rates, which in effect would be requiring the banks to underwrite some of their own losses, or are we simply going to have the IMF bail them out?

Secretary SHULTZ. Well, our objective is the reverse, to bail them in: to keep them in the action, to keep them increasing, and taking part in the preservation of liquidity in the system.

I think that if there are widespread defaults around, they are out. They may take an awful beating, but I think we get very little satisfaction out of seeing some bankers given a hard time.

So our objective is to keep them in, to bail them in, to insist that they stay in, and through that means, to get through this sad spot that we have.

Senator JOHNSTON. I understand that, but what is fair, and how are we going to get them to participate with their capital, as well as IMF's capital which really is taxpayers' capital?

Secretary SHULTZ. Well, as these programs get developed, with the IMF, as the sort of center, they have lots of discussions with private banking groups, and with the individual governments involved. They try to get understanding of how this is going to take place, and who is goinq to do what, including the private bankers.

Other bankers have their own problems, because for the most part these large loans are syndicated, and you always have to keep your whole syndicate together, and that in itself is a nice job of management. So it is hard going.

BANKS WILL BE BETTER OFF IF PROGRAM WORKS

Senator JOHNSTON. As this matter matriculates through the Congress, people are going to want to know, I believe, how we are going to insure fairness. To say only that it is a complicated problem is simply going to result in a lot of them saying, "There goes the taxpayers' money, bailing out the biggest banks in the country."

Secretary SHULTZ. I think it is a fair statement that if this program is successful, banks across the country will be better off than they would be if we did not do this.

In that sense, they are going to gain, but if we all gain, I think that is appropriate.

Now, there are a lot of bad loans, and no doubt the people who are scraping the portfolios around in the different banks are going to wind up having to write a lot of those off, and it is going to have its impact on bank earnings, I would think. Some banks a lot more than others.

PURSUE ENERGY POLICY WITH MEXICO

Senator JOHNSTON. Mr. Secretary, Mexico is in deep economic trouble, and it seems to me that now is the time when a hemispheric energy policy really makes sense. President Reagan talked about it when he ran, and it did not seem to make much sense, frankly, to me, at that time, but it does now.

By such a policy, I mean long-term deals for crude oil, for natural gas, for pipelines, et cetera. Why should we not aggressively pursue a policy with Mexico, and to some extent with Canada, but particularly with Mexico, that would insure our long-term access to those supplies?

Secretary SHULTZ. Well, I think we should be pursuing our relationship with Mexico across the board and in terms of energy and other matters—all consistent with their sense of sovereignty over their own resources. Nevertheless, those are resources they want to export and we are next door and we are a pretty good customer to have. So I think there are a lot of ingredients for working out matters in a satisfactory way. And I think it is also the case that the more dependence that we have on our neighbors as distinct from people who are a long way away, the more secure we are in our supplies.

Senator Johnston. Should we not effectively pursue that with a high level initiative?

Secretary Shultz. It is being pursued.

Senator Johnston. One final question, Mr. Secretary. We were told yesterday by experts in the Energy Committee that the possible collapse of oil prices could be down to as much as $25 a barrel or more, even $20 a barrel some suggest.

It seems to me that the Saudis are highly susceptible to some interdiction of their oil supplies as Iranians need money and other traditional foes of the Saudis need money and they look at the Saudis' huge productive capacity which could be interdicted by a commando raid or an Air Force raid. Are you concerned about the vulnerability of the Saudis and, if so, what can we do about it and what are we doing about it?

Secretary Shultz. Well, those supplies have been there for a long time and they have flowed, so the historical record is that that supply line has been a reliable one. Obviously it is in a part of the world that has a major war on right now between Iran and Iraq, so there is a sense of instability in the region.

But, on the historical record, it has been a reliable source of supply.

Senator Johnston. Thank you, Mr. Chairman.

Chairman Domenici. Thank you, Senator.

Senator Boschwitz.

IMF SETS GROUNDRULES

Senator Boschwitz. Mr. Secretary, your testimony this morning has something of a familiar ring today at the Foreign Relations Committee. The IMF is really not that large a lender—is it fair to say that the IMF is not that large a lender but it sets the pattern that world banks have a tendency to follow. And as you point out in your testimony, banks—I thought it was more than $4 for every $1 that the IMF lends, every $1 that the IMF lends according to your testimony, banks lend $4. So that the IMF kind of establishes the groundwork and the rules under which it will borrow and give assurances to world banks that that country is going to follow some more stringent fiscal policies and, therefore, those world banks should expand their participation. Is that a fair statement?

Secretary Shultz. Yes, sir.

Senator Boschwitz. And also in response to Senator Kasten, you point out that this is a matter of budget authority rather than budget outlays but, nevertheless, it does impose itself on the lending system here in this country.

I notice in our—that we will be meeting with Secretary Regan in the Foreign Affairs Committee and we will discuss all of the multilateral banks and, in some instances, some of the contributions to those banks spread out over 4, indeed over 10 years.

Is there any way that we can do that with the IMF; that we can spread our participation out over more than a single year?

Secretary Shultz. Well, we have to authorize it so that they know that they have the capital which they can call and use. Just when they actually do it I think is a question of their needs.

Senator BOSCHWITZ. Have historically they called upon that within the year that the budget authority is authorized?

Secretary SHULTZ. I will have to give you an answer for the record on that just to check. I do not know offhand what the exact facts are.

Senator BOSCHWITZ. The last time they asked for a large increase was 3 or 4 years ago, is that correct? Two, three, four years ago?

Secretary SHULTZ. I will have to check on that, Senator. I do not have that right on my——

[The following was subsequently supplied for the record:]

WRITTEN QUESTIONS FROM SENATOR BOSCHWITZ TO SECRETARY SHULTZ AND THE RESPONSES

Q: Is it possible to spread our subscription to the IMF out over a period of years?

A: -- The basic objective of the quota increase is to equip the IMF to respond to temporary official balance of payments financing needs in order to maintain a stable international monetary system. It is not the purpose of the quota increase to finance a regular lending program in which there is a predictable schedule of disbursements.

-- For this purpose, financing must be available when the need arises to meet the demand for IMF resources both to deal with "normal" circumstances and to respond to extraordinary situations which threaten the stability of the system.

-- Consequently, quota subscriptions must be made at the time agreed by the IMF membership. The Interim Committee has agreed that the quota increase be implemented by the end of 1983. Failure to subscribe to our increased quota in full at the time the general increase became effective would result in a loss of U.S. quota share, a decline in our voting share, and possibly a loss of our veto.

-- In practice, the increased U.S. quota subscription would result in actual cash transfers to the IMF only over a period of years. The increased U.S. quota subscription is to be made by paying a portion (25 percent) in SDRs and foreign currency and the remainder (75 percent) by increasing the IMF's letter of credit with the United States. When the Fund requires dollars to finance drawings by other countries, the IMF will draw down on the letter of credit and the Treasury will transfer funds to the IMF. Similarly, when the IMF receives dollars (e.g., resulting from repayments by other IMF members), funds are transferred from the IMF to the Treasury and the letter of credit is increased.

-- The net effect of transfers to and from the IMF has varied widely over the years, resulting in cash outflows from the Treasury in some years and inflows to the Treasury in other years. Over the past decade, all U.S. transactions with the IMF have resulted in net cash transfers, and consequent increases in Treasury borrowing requirements, averaging less than $500 million annually.

-- It is not possible to project reliably the effect on Treasury borrowing requirements of U.S. transactions with the IMF because of uncertainties regarding the future level of IMF financing, and the portion of such financing that would be in dollars. Any net transfers to the IMF would, however, be spread over a number of years. On balance, we would not expect any net transfers of dollars to the IMF arising from the quota increase to exceed something on the order of $1-1.5 billion annually.

Q: Does the IMF historically call in increased subscriptions within a year?

A: -- The quota subscription must be "paid" in full at the outset.

-- However, a portion (25 percent) is paid in SDRs or foreign currency and the remainder (75 percent) is paid by increasing the IMF's letter of credit with the member.

-- The 75 percent currency portion may or may not be called (resulting in actual cash transfers) depending the level of IMF financing; the use of the member's currency for IMF drawings and repayments; and whether the country itself is using IMF resources.

-- The IMF is essentially a revolving fund of currencies; all members are obligated to allow their currencies to be used to finance drawings by other members and all countries have a right to use IMF resources to meet a balance of payments need. The U.S. quota subscription has been used frequently over the years and the U.S. has drawn on the IMF on 24 occasions for a total of about $6.5 billion, the second largest use of the entire membership.

-- Thus, in some years the U.S. has transferred funds to the IMF and in some years the IMF has transferred funds to the U.S.

Q: When was the last large IMF capital increase?

A: -- The last IMF quota increase took effect at the end of 1980 and raised overall quotas from about SDR 39 billion to roughly SDR 60 billion. The U.S. quota was increased by approximately 50 percent, or SDR 4.2 billion, to its present level of SDR 12,607.5 million.

Senator BOSCHWITZ. Mr. Secretary, do you know if other countries stage in their participation?

Secretary SHULTZ. They would do it as we do it.

Senator BOSCHWITZ. Is there any way that——

Secretary SHULTZ. And we are sort of a bellwether in this. We have the largest quota but also people have become more uncertain about whether we will do what we say we will do. So they watch to see what kind of action will be taken by the United States.

Senator BOSCHWITZ. Our quota is about 18 percent as I recall the figure, is that correct?

Secretary SHULTZ. I thought it was about 21 percent but anyway it is about that range.

Senator BOSCHWITZ. In that range.

Is there some way that the IMF would, by and large, set the pattern for lending, could lower the amount in loans and having once set the pattern that the world banks that have gotten themselves into this enigma that they could be required to bear a larger share than the customary 4 to 1?

Secretary SHULTZ. Well, I think the 4 to 1 is sort of the result of an historical study of what had happened after IMF programs have been put into effect, and it is reflecting that the private banks have followed on with lending. It is to the point that the phrase, I think, was coined by Jacques de Larosiere of the IMF that they are being bailed in rather than being bailed out. The historical precedent is there and certainly in the negotiation of these programs. The expectation of private lending is there.

IMF TOUGH ON EVERYBODY

Senator BOSCHWITZ. If historically the private banks have loaned 80 percent, could the IMF now in effect tell them that they have to go to 90 percent and thereby lessen the amount that they would require from the member nations?

Secretary SHULTZ. I think it is hard to set up a rule like that with some percentage because the IMF has to work——

Senator BOSCHWITZ. It does not have to be set up with the rule——

Secretary SHULTZ. It has to work with each country and countries vary a lot in terms of the appraisal of them by the private banking system and what sort of program they are able as a political manner to actually institute and make work. So there are a lot of variables here from one country to the next.

Senator BOSCHWITZ. But the IMF cannot go to the bank and say, listen, you have gotten yourself into this, you have chased these people, as soon as they had a few dollars coming in from oil, you went out and loaned them more and got, you know, encouraged them to get into what is essentially quite a mess; that we are not going to loan them as much but we are going to give you the guidance that we normally have given in the past and that it does not have to be a rule.

Secretary SHULTZ. My impression is that the IMF is pretty tough on everybody.

Senator BOSCHWITZ. Well, I will explore a little bit with Treasury perhaps on whether or not they can be a little tougher on lending less and requiring less from its members.

Secretary SHULTZ. I think you will find the Treasury is pretty tough. Don Regan did not develop the largest financial services firm in the world just out of being an easy pushover.

Senator BOSCHWITZ. He is coming before the Foreign Relations Committee, I think tomorrow, and I will talk to him about that.

Can it be done with guarantees rather than with budget authorities, by chance, and thereby have less of an impact on the borrowing—lending system of the country?

Secretary SHULTZ. I think we have to have the authority authorized by the Congress in order to get the money. There has to actually be money up and so the Treasury has to go out and borrow it.

REDUCTION OF FMS TO KOREA

Senator BOSCHWITZ. I see that my time is up and I have to wait for my second round of questions. But I would like to comment on the reduction of FMS to Korea, which I was not aware of. I do not recall that we reduced FMS at all inasmuch as it did not have a budgetary impact also from its budgetary authority, but I would like to point out that while we may have reduced that, I believe that we have 33,000 troops or so in Korea. Secretary Schneider, who is with me today, testified the other day in making a comparison in Turkey that it cost $9,000 to maintain a Turkish soldier, $60,000 to maintain one of our own. On that basis, we give $2 billion a year to Koreans by our very presence there. That comes under tbe military budget and does not come under the foreign relations budget, but I do not recall that we reduced the South Korean foreign military.

Secretary SHULTZ. Well, Senator, it was not a question of taking steps to reduce various programs for different countries but rather that when a total is set and then earmarking comes up against that total, you have some amount left and you have to spread that around. If it is a lot less than you are counting on, you have to cut in some places as you program it, and that is what Under Secretary Schneider had to do. And then recently he had to travel around to those countries and give them the bad news so it was a wonderful trip, was it not?

Senator BOSCHWITZ. I do not recall that we earmarked FMS. I do not recall that. Perhaps Senator Biden has a better recollection than I do, that we earmarked some of the grants, that we changed some of the concessional loans into partially grants and partially FMS, as I recall.

Secretary SHULTZ. Do you want to comment on that, Bill?

Mr. SCHNEIDER. Seven countries were earmarked and some of them had the FMS levels earmarked as well, which has created part of the problem of the base rights countries, for example, because they did get the FMS funds earmarked. This created a problem when we got to countries like Korea and Thailand where we just ran out of the FMS to do it under the funds appropriated under the second continuing resolution.

Senator BOSCHWITZ. I will come back.

Chairman DOMENICI. Your time is up, Senator.
Senator Riegle.

MANUFACTURED GOODS ACCOUNT IS DISTURBING

Senator RIEGLE. Mr. Secretary, it is nice to have you here today. As you know, we are still plagued with a very severe recession here in the United States, at least as one would measure it by unemployment because we have no question over 12 million people unemployed and no prospect of any major change in the unemployment situation, at least in the immediate term. It looks like it is going to take some time to work that down; in fact, even the unemployment projections of the President's budget suggest as much.

So I would like to just chat with you for a minute about the trade side of this issue and how we take and hold the financial structure together internationally which I also feel strongly needs to be done but how we do that in a way that is also healthy for our own economy and bring these jobs back home and help us restore our job base more than we have been able to do so far. I know this is an interest of yours. This goes back over a long period of years in your previous service in Government, in terms of the labor force and how policies impact on jobs in this country.

I am disturbed right now about what I see happening in the manufactured goods account under the balance of payments, and in 1981 we were running about a $12 billion surplus in the manufactured goods account. And as you were referring earlier, many of those goods were being sold to less developed countries. Now, there has really been a breathtaking change in the performance in that account partly because of these austerity measures that Mexico and Brazil and other governments have had to impose but suddenly we find that we are not selling nearly as many manufactured goods abroad and, as a matter of fact, the problem has sort of gone the other way where their goods have become more competitive in our market. We are the most open market in the world. We were running at a rate of roughly a $12 billion deficit in terms of the most recent data I saw on a monthly basis, within a couple of months ago. So within a period of a little over a year, we have had a $24 billion swing in just the manufactured goods account.

Now, you know the unemployment rates in States like Michigan and now West Virginia are up over 17 percent. But the thing that concerns me here, as I look at this, is that we are going to continue to make more credit available abroad and in the nature of the relationship in order to deserve that credit, they have to cut down on their imports which means that we have a tougher time exporting our goods to them; that we are going to see this manufactured goods account continue to suffer as it is now. In fact, the deficit in that account is rising at an expedient rate and I do not know how far that could continue, but I have seen estimates that say it could go up higher than a $12 billion deficit and substantially more than that.

MAKE DOLLAR CREDITS IN THE FORM OF IMF

So what I am wondering is this, are we at a point right now where the best thing to do is to take and just make dollar credits in the form of IMF, of allowances or other forms of credit available to these countries for them to use as they will? I mean they use it for a variety of purposes and there are all kinds of trade-offs in terms of how they use their money.

I asked Secretary Regan the other day, I said what percentage of that money actually comes back directly to the United States? His estimate was about 40 percent. I do not know if you would agree with that or not; in the course of your response, I would like to have your best estimate.

But if that is accurate, as accurate as we can be, then 60 cents out of every dollar does not come back here in the form of either job creation or goods production or what have you. Why would we not be better off now with these countries that are in this difficulty in giving them credits for goods here in this country that we would produce? In other words, if we are going to make available another 5 or 6 billion dollars worth of credit, why not make the credit available in the form of items, whether they be agricultural items or manufactured goods or whatever, that we actually produce here in our own country, give our folks new jobs and by that means extend the help but not do it in a way that is going to cause us actually to lose jobs, which seems to me to be the problems right now, particularly with the underdeveloped countries?

So why would we not be better off going that route? And how do we solve this manufactured goods deficit which is rising faster than I am aware that it has risen in recent times?

Secretary SHULTZ. Of course, we do have a lot of credit that is tied. The IMF increase is really designed to help that organization help us and others to keep the world economy on an even keel, and we benefit tremendously from that, assuming that we will be able to achieve it as I think we will be.

U.S. DOLLAR HAS BECOME VERY STRONG

I think you identify a very important problem for us, and there is another factor that seems to me to be accounting for a lot of the problem, exactly how much of it I do not know, but it is not only the fact that the demand in developing countries where a lot of this produce has gone has fallen off. It is also because our dollar has become very strong, and so that has changed the relative cost position of our goods as compared with goods from other countries and, I believe, has accounted for a good bit of this swing.

Now, you are asking yourself why has the dollar become so strong, and again I cannot say precisely, but I think it has a lot to do with financial flows. We are having something of a Switzerland effect in this country where, all of a sudden, our balance of payments is being heavily influenced by financial flows over and beyond the flows of money connected with trade. I think this is partly due to relatively high interest rates, but the interesting thing is that even as interest rates have come down, the flows have continued.

I think there is a definite sort of a safe haven aspect to these flows and they have produced, by the market, legitimately, a dollar that is very strong and has had the effect of pricing a lot of our goods out of the market.

Having stated that as a problem, I do not know exactly what the right thing to do about it is, but it does seem to me to be a great problem which dramatized to me in a meeting that I had a couple of months or so ago with some business executives, and particularly Lee Morgan, who is the chairman of Caterpillar Tractor. He brought it out in terms of the sales of caterpillar tractors. It is a particularly good case because here is a company that has a wonderful product, well managed, accustomed to selling around the world. They know how to be in world markets; they are very experienced and sophisticated. It was just like throwing a switch what happened to them. As a result of the—in this case—yen-dollar relationship.

Senator RIEGLE. Well, would you agree—you notice how the 5-minute time limit works—one serious question and no real change for follow-up.

MONEY COMES BACK MANY FOLD

Do you agree with Secretary Regan's estimate that about 40 cents of a dollar actually comes back directly into the U.S. economy and is used here?

Secretary SHULTZ. I would have no basis for an independent calculation. If I were seeking the answer, I would ask the Treasury which works directly with the IMF. I would quarrel with it in this sense, that if the result is to keep the world economy moving and to lay the basis for expansion, then I think it comes back to us many fold, not just 40 percent. And that is the real point of that IMF program.

Senator RIEGLE. Well, I hope you are right. The problem is that we are very scarce on credit in this country, as you know, and have been now for some period of time. And so in a period of credit scarcity and higher interest rates, to take a chunk of that ciedit and send it abroad when only less than half comes back in the form of employment opportunities in this country is an awfully painful step to take right now.

Secretary SHULTZ. Yes, I would like to think that it comes back many fold for the reasons that I have stated.

Senator RIEGLE. Thank you.

Chairman DOMENICI. Thank you, Senator Riegle.

Senator Grassley, you are next.

I wonder if I might ask a couple of questions. I have to go, I am 30 minutes late, to a chairman's meeting, and if one of you could stay and preside.

Senator GRASSLEY. Can I be next then after you?

Chairman DOMENICI. Yes. I only have two or three quick questions.

SOME FEEL LOAN GUARANTEES OUT OF CONTROL

I think Senator Johnston hit the nail on the head, Mr. Secretary. If you are going to get support for the proposals that you brought forth here, in particular the IMF, I think we have to address the issue of the major banks of our country. I realize that this IMF legislation is not intended to be some kind of a bailout but rather, as you put it, a bail in. I think, however, that there is a growing understanding on the part of the American people that our large private banks have made a lot of bad loans in foreign countries. Obviously with better economic times many of the loans might have turned out to be good decisions. Our people have a lot of questions about American resources going into the world by way of Federal loans or loan guarantees. There is a feeling that international lending and foreign aid are out of control. I think many people were astounded during the Polish situation to find how many American guarantees existed in Poland. That is not to say the decision to issue the guarantees was good or bad to begin with. Financing for an Eastern bloc country certainly is not consistent with the notion that we are going to help underdeveloped countries.

Mr. Secretary, I would hope that either your Commission or you and the administration will be able to give us more assurances that this IMF increase will not be a bailout and that the large commercial banks are going to have to do their share. I think four or five questions today have been directed at that issue one way or another.

I personally would like to see more assurance from you that the banks will do their share to get us through this international problem. Also, I hope you can convince us and other members of the Senate in the next few months that that is the case.

Secretary SHULTZ. I think they should do their share. Just to take the Polish example, I think the record will show that the private banking system began to scratch its head about Poland long before the Government credit system did.

Of course, in the case of Poland, the major credits have come from the Europeans more than United States in terms of proportions.

I would say also that a lot of those credits had to do with selling farm commodities to Poland, with promoting exports.

FIGURE OUT PROBLEM TOGETHER

I would make one more statement in defense of the private sector. You know, the Government sector is pretty hard to figure out if you are out there as a private businessman. We inflated, created an atmosphere that encouraged a lot of activity that now in retrospect is questionable. Who would have thought that the U.S. Government on the one hand would follow the inflationary policies that it followed and then would be able to successfully carry off with all of the pain and agony involved a program that would cut the rate of inflation to one-third of what it had been. That is a shift.

Who would have thought in the face of the energy crisis that we would throw on price controls and keep the price suppressed below what it was in many other countries, even though the evidence is pretty clear now that once you take the controls off, you get an entirely different kind of a situation. So I suppose it is just because I have spent a lot of time in the private sector and only recently reentered the public sector that I still feel like those guys and gals out there. We can criticize them but they can also look and see what we do and say, you know, you guys are not perfect either.

So the point is we have a problem out of all this, a big problem. We are in it together and we have got to figure out the best way to get out of it together.

Chairman **Domenici**. My last question, in a sense, is related to Senator Riegle's question. You discussed a solution based on our getting the whole free world economy moving again. At one point you even mentioned that the reduction in oil prices will be very salutary to the free industrial nations. I do not have any argument at all with that. You mentioned specifically it would be very good for Japan. I understand that also.

COMPETING ADEQUATELY AS WORLD GROWTH OCCURS

But I wonder if you think we are taking a hard enough look at our own domestic laws to determine whether our private export sector is able to compete adequately as this world growth occurs? It seems to me that the one thing we are apt to be confronted with is that we will get our economy going only to find once again we do not get our share of export growth. Is it because we are doing something wrong as a matter of policy in terms of encouraging management and labor and financial relationships in this country to keep as competitive?

Does that concern you at all?

Secretary **Shultz**. It concerns me and I think it is a tough competitive world out there. And if you are going out and sell in it and make money in it, you are going to have to be pretty good and you have to be in the process of getting better.

Personally, I have a great deal of confidence in the capacity of American management and workers and research and development to maintain a competitive edge. We have done so in the past; we can do so in the future.

In many ways Government helps those who are out there in that competitive marketplace. There are a lot of ways in which our Government does not help. Some of them were brought out by questions having to do with agricultural trade. I think that the use by our Government of trade, as a tool of foreign policy, has hurt us competitively. There is no doubt about it whatever.

I do not say that we should not do it, and it has not been right to do it. But I think we ought to be very careful in any time that we do it because it does have an impact.

Chairman **Domenici**. Thank you, Mr. Secretary.

Senator Biden.

Senator **Biden**. I yield to Senator Grassley.

Senator **Grassley**. Thank you, Senator Biden. I appreciate that very much.

Most of the comments today I know have been on this $8.5 billion IMF loan. I only want to express a view before I ask a question, and then for those of us who have been struggling with the concept of the freeze in trying to institute that as a matter of getting something adopted, that is fair to all segments of our economy and all of our programs, it does not fit very well into that, but that is just my view, and that is something that we are all going to have to struggle with. I just want you to know that.

Beyond that though, we also have been struggling here with the concept of cost overruns. I suppose we dealt with that mostly in the area of defense, but then, of course, a lot of programs have cost overruns, not just defense programs. The bottom line of that is that you say it is very difficult to guess far out what this total bill could be. So, you know, that is another problem for us with this. It has obviously got some admitted cost overruns right now.

When you say that you cannot, in answer to Senator Kasten's question, you cannot really tell what the full impact might be as time goes on. So I would ask you to try at least give us as tough and as strong a figure that you can that will withstand our view in the future as we look at it.

PROMOTE GROWTH POLICIES

Now, to the point that I would like to make that I do not think has been made yet today, and that is that the IMF naturally is putting a precondition on their loans to these nations that they adopt austerity measures. It just seems to me like we ought to take the opportunity now that so many of the underdeveloped nations who have had an economic philosophy, that have not been expansionist in its orientation to have our administration, with their economic philosophy be felt in these countries and that would be to reject austerity, but to promote growth policy that is going to cause these individual nations economies to expand so that they can meet their economic needs so that they can pay their bills as opposed to the austerity policies that is not going to create which policies are not going to create any new wealth.

Now, is it not legitimate that we be interested in promoting growth policies in these countries; is it not legitimate that when we are being called upon to help these economies that we take advantage of that opportunity to so do and then, are we not in the long run then doing these countries a favor if we promote growth policy as opposed to policies that cause our economy to shrink?

Secretary SHULTZ. I agree with you. I think we should promote growth policies.

It is nevertheless the case in a lot of these instances that they have a budget that is not in control and they have a trade posture that is not in control, and they have to do something about it in the short run to get their base in more solid shape. But certainly we should be promoting policies that will lend themselves to expansion. I agree wholeheartedly with that idea.

Senator GRASSLEY. Well, are we doing that?

Secretary SHULTZ. We are certainly trying.

Senator GRASSLEY. It is difficult in the short term, you are saying?

CARIBBEAN BASIN INITIATIVE

Secretary SHULTZ. Now, to give an example, the Caribbean Basin Initiative has a trade and tax aspect to it in addition to the aid aspect. The aid aspect passed the Congress last year. The trade part passed the House by a comfortable margin but it did not make it in the Senate. The President has proposed it again today, and I spent the early part of the morning with the President and the Prime Minister of Jamaica hearing about this.

But what is the objective? The objective of that is to open up our market so that the countries of the Caribbean can develop their own industry and have a place to sell their product, and I think that is essentially the kind of policy that you are talking about.

Senator GRASSLEY. Did you bring that up because I voted against it?

Secretary SHULTZ. Well, I just wanted to make a point.

No, I did not think the Senate voted on it.

Senator GRASSLEY. We voted on it in the Finance Committee.

Secretary SHULTZ. You did not come to a vote.

Senator GRASSLEY. I voted against it in the Finance Committee. I was one of those who objected to it.

Secretary SHULTZ. Well, you ought to think it over, because this is a policy for expansion.

Senator GRASSLEY. OK.

EXPANSIONIST PHILOSOPHY IS APPROACHING

Are we generally approaching an expansionist philosophy as we go into individual countries long term, even though you say it is difficult short term?

Secretary SHULTZ. That is our philosophy and that has to be everybody's philosophy. The——

Senator GRASSLEY. It obviously has not been the IMF's philosophy. They rejected the concept that they should interfere in the internal economic policies of the country except as they impact upon the ability to repay, and that is immediate repayment.

Secretary SHULTZ. Well, you have to get your house in order when it is way out of order before you can go on and do other things. And the IMF has also been warning against, as many people in this country have, the dangers of inflation and stressing the importance of getting inflation under control. You probably made that speech yourself. The IMF has been making it and making it oftentimes when it was very unpopular. But you have to be willing to take the disciplined measures that will bring inflation under control and I hand it to them. But having done that, I think that certainly they and we must be in favor of policies that will expand economies around the world. I agree wholeheartedly to that.

Senator GRASSLEY. Thank you, Secretary Shultz.

Senator KASSEBAUM [presiding]. Senator Biden.

Senator BIDEN. Hello, Mr. Secretary. Nice to see you before this committee. There have been a lot of questions asked, the time is short, and I will try to be brief and precise in my questions.

CUT IN MILITARY AID TO ISRAEL

Why the cut in grant military aid to Israel? Why are we proposing a—what amounts to, as I read it, in terms of grants, a $200 million cut in the administration request for military aid to Israel?

Secretary SHULTZ. Well, Senator, we did not go along with the addon and we had quite a lot of discussion about that.

Senator BIDEN. If I could help you there. Did you not request $750 million last year in grants?

Mr. SCHNEIDER. No, you requested $550 million.

Senator BIDEN. We requested $550 million, and we forced the $750 million on you.

Mr. SCHNEIDER. That is right.

Senator BIDEN. And you are moving back to your original request?

Secretary SHULTZ. It has been rearranged somewhat in terms of the distribution internally between grants and——

Senator BIDEN. As I read it, the loans are increased by $100 or $200 and—$200 million, and the grant is increased by $200 million, is that correct?

Mr. SCHNEIDER. That is correct, Senator.

Senator BIDEN. And why the change in the proportion?

Mr. SCHNEIDER. When the Congress added the additional funds last year, that increased the proportion of grant and decreased the amount of loans, the administration's view was that this altered the balance between the military assistance we were giving on the worldwide basis and given the budget problems that we have this year to raise the—or to retain the grant portion that the Congress added on last year would create just insuperable problems for us and the rest of the world. So we for fiscal 1984 went back to approximately the same level that we had requested in fiscal 1983.

EL SALVADOR'S PROBLEM MORE ACUTE

Senator BIDEN. Why increase the grant for El Salvador by almost $50 million?

Mr. SCHNEIDER. Well, in that case it relates to the exigencies of the problem that they now face, where they have an active miltary conflict on, and the tactics of the opposition forces are going directly at, in effect, their ability to pay, by striking at the economic infrastructure.

In the case of El Salvador, in order to support our foreign policy objectives there, we are obliged to make available resources on more concessional terms.

Senator BIDEN. Is not the infrastructure of Israel in abysmal shape right now? They will be paying back more in interest than they will be getting from us in loans for the first time as I understand this year, correct me if I am wrong, and I do not see anything particularly bright about Israel's economic picture right now?

Mr. SCHNEIDER. No, I would not disagree with that. They have serious economic problems as well.

The problem in El Salvador, though, I would argue, is even more acute, because there is an active conflict engaged there now.

Senator BIDEN. Well, maybe I can get you into this, Mr. Secretary.

Secretary SHULTZ. Not if I can keep him in it. He is doing fine.

Senator BIDEN. I would like very much to get you in.

Let us talk about Turkey for a minute.

I do not understand, number one, why at this juncture, when we are negotiating the base agreement with the Greeks, we are increasing the loans by $175 million, if I read it correctly, and grants for military aid by $110 million over a $300 million—approximately $300 million increase to Turkey. While we are cutting grants to Israel, that cannot even pay back now, they are paying more in interest than they are getting, while—I mean, I just do not understand the mix.

What is so urgent in Turkey today, that is not even more urgent in Israel, and quite frankly, urgent in Greece today?

Secretary SHULTZ. Well, there are urgent problems everywhere.

Senator BIDEN. Right.

Secretary SHULTZ. That is the difficulty in this budget process, and I do not think there is any infinite amount of money that we are going to be able to persuade you to appropriate.

Senator BIDEN. Just talking about priorities.

TURKISH ECONOMY NEEDS SUPPORT

Secretary SHULTZ. Therefore you have to cut and fit.

Now, in talking about the Greek-Turkey problem, the Turkish economy is also in tough shape, although improving, and it needs support, and their military position is an essential one, in their location, if you look at the map, and therefore we have sought to build up.

Now, in terms of Greece, of course, that is straightlined, but that is basically in view of the fact that we are in the midst of negotiating now on the renewal of the base agreement, and so whenever it seems appropriate in negotiations, the amount for Greece in effect would come forward in the form of a supplemental, I suppose. So that is there in view of the negotiations, and as the negotiations unfold, a different number would come forward.

Senator BIDEN. My time is about to run out. Let me make two points, if I may, somewhat presumptuous, but I have found, unlike any other Secretary of State I dealt with, you sincerely listen. You do not always agree, but you listen, and I appreciate that.

I would strongly urge, once again, that we have a problem with the Popinvanov government. Now is not the time to be increasing aid to Turkey. I acknowledge it is also not the time to be increasing aid to Greece, and notwithstanding the fact that the 7 to 10 ratio is one that is not sacrosanct here, it in fact is a politically sacrosanct ratio, and I think you are making a gigantic mistake changing that ratio now.

No. 2, with regard to Israel, I do not think now is the time to cut back what has occurred last year in terms of grants, and I would strongly urge once again, now is not the time to be moving forward with Jordan. Things are too volatile now, and I would hope that we are going to get a chance in the Foreign Relations Committee, I know we will, to pursue both of these questions.

I can assure you that I will be pursuing them all with all the vigor that I am capable of exerting, but I thank you for listening. I do not expect you to respond. I know you are too sharp to want to respond at all. So I will drop it at that.

Senator KASSEBAUM. I would just like to say, the Secretary has a time problem, and I would guess 10 minutes more at the most, so if we could gauge that.

Senator Symms.

Senator **Symms**. Thank you very much, Mr. Chairman.

Mr. Secretary, sitting here listening, and I scanned through your testimony, you made the case, and I think Senator Biden touched on it, we do things, we give aid, military assistance to countries that are our allies and friends, because it is cheaper to have a Turkish soldier on the border than it is an American soldier, or a Korean, or have an Israeli fly the F-16, rather than an American, whatever the case may be.

I hope we do those things that we think are in our best interests, but I guess you generally agree with that, do you not?

Secretary **Shultz**. Absolutely. We do not do anything unless we think it is to our best interests.

SOLVE PROBLEMS PEACEFULLY

Senator **Symms**. The one thing that keeps coming up to my mind all the time is the question comes up in the case of Free China on Taiwan, where they want to buy the F-5E, which is now called the F-20. I have not yet—I have not yet been able, for the life of me, to understand what is the logic in the United States policy that somehow tells us that we cannot sell an airplane to someone who has been our longest and best and most loyal ally, when they are the ones that have determined (*a*) They are the ones that can afford the airplane, and (*b*) it fits the capabilities that they perceive that they need; when you do not have to be a military strategist to look and see that if you did have the capability of the later version of the aircraft that they now have, just so the record is clear, it is the F-5G, but it has now been called the F-20.

I think Northrop has changed the name of it, but we are talking about the same airplane. What is the logic of us not allowing Free China to purchase those aircraft, that would be like—it is like having 10 aircraft carriers in the Straits over there, to have it—to have them have that aircraft, if and when, heaven help us, if the curtain ever did come down?

Secretary **Shultz**. Well, the logic is that we are committed to doing what we can to see that any problems involving the Chinese on Taiwan and the Chinese in the People's Republic of China are resolved peacefully.

Both agree that there is one China, and Taiwan is part of it. They both say that. They do not agree on what the follow-up of that is, and we say, well, it is a dispute, and as far as we are concerned, our idea is that you should solve it peacefully. And to that end, following the Taiwan Relations Act, a communique was negotiated, signed off on by the President, that we could expect that the sales of armaments to Taiwan would be likely to decline in view of what seems to be a generally peaceful situation in the approach to those issues.

So that is the logic of it.

Senator **Symms**. I will, Madam Chairman, yield back my time, but let me say I hear your answer, but I find it very difficult in terms of our prospective of liability to the entire world, of having a policy to support our friends, which I think is a good policy, is to support our friends, to not allow them to make the decision on which airplanes they should buy, and I guess that is my conflict with that policy, and I do not think that it would interfere between Communist China and Free China, but that is my opinion.

Thank you.

Senator KASSEBAUM. Senator Sasser.

Senator SASSER. Thank you, Madam Chairman.

Mr. Secretary, welcome.

GET INTERNATIONAL EFFORT GOING IN PERSIAN GULF

I want to ask you a question this morning about the Persian Gulf area. I am very concerned about the burden that American taxpayers are being asked to carry, to shoulder what appears to me to be a common defense. The British left the Persian Gulf area in 1971, silently, folded their tents and silently stole away, and up until that point they had been primarily responsible for the defense of that area, in keeping the oil pipelines open.

Now we find that the United States, putting together the Rapid Deployment Force, the startup costs of $20 million, 230,000 troops, is taking over the defense of the Persian Gulf area. This at a time when I am advised that we are only getting 8 percent of our oil from the Persian Gulf area, at a time when our friends, the Japanese, are getting 75 percent of their oil from the Persian Gulf area, at a time when our trade has declined some 30 percent over the past 5 years in that area, at a time when again our friends the Japanese are the No. 1 and No. 2 traders in that area. I am concerned as to why we are having to pay the bill here, and would it be possible to get some sort of international effort going to safeguard the pipelines, oil pipelines, that are so vital to our other allies, and appear to be less and less vital to us?

I was interested to see Prime Minister Nakasone when he came to this country, make some statements which indicated that the Japanese wanted to bear a larger burden in the Northern Pacific. I was also interested to see that when he returned home, that those statements did not play too well in the Japanese domestic environment, and I am not sure that the Japenese are that concerned about defending the areas in the Northern Pacific, but I have a hunch that those Japanese businessmen who depend on oil from the Persian Gulf area to fuel their industries, they might be more concerned about guaranteeing the security of that oil pipeline.

What efforts are we making, Mr. Secretary, to get a stronger international effort going in that area, and relieve the American taxpayer of some of this burden that they are having to bear here?

OTHER COUNTRIES READY TO PAY

Secretary SHULTZ. I do not think the American taxpayer is putting up much, Senator. The countries of the gulf are, by and large, are ready to pay for, and able to pay for military equipment.

Our argument here is whether we should sell it to them or not, but they are not asking for us to put up the money in Saudi Arabia, or elsewhere, they are ready to put up the money.

Now, the Rapid Deployment Force, which you referred to, is of course, designed to be a tool that we can use anywhere, it can deploy rapidly, but just where, of course, is to be determined by the needs, and that is the whole point of it. If we knew where it was needed to deploy, we would put it there in the first place, and the rapid deployment idea would not be so necessary. So it is a multipurpose concept that is involved in that force, and it is designed to help defend the interests of the United States around the world.

As far as Japan is concerned, it is the case that Prime Minister Nakasone made some statements that got a negative reaction from some corners in Japan. I do not suppose the politician exists who takes any important position that has not found that when he or she does that, there is somebody who does not like it.

The question is whether or not he stands up to the things that he set out to espouse, and when it comes to an election, is able to commend the following. I thought that he was very impressive when he was here, and when I met with him in Japan, and in fact, I think the whole new Nakasone government is consistent, extremely——

Senator SASSER. I am not being critical.

Secretary SHULTZ. And as far as Japan sending forces around the world are concerned, they have a constitution that we had something to do with, that puts severe restrictions on the use of Japanese troops outside—in fact, it does not just put restrictions, it commends them not to send their troops outside the defense of the Japanese homeland. That does not mean that they cannot contribute funds, and support, and on the whole, they do, and we are trying to buoy them up in that respect.

THERE IS ROOM FOR JAPAN TO DO MORE

Senator SASSER. Rather than us building some new *Nimitz* class carriers to carry out our mission in the Persian Gulf area, and us paying for it, it might not be a bad idea, in my judgment, Mr. Secretary, and I would suggest this, just throw it out here, that perhaps the Japanese could be asked to subsidize the building of some of those aircraft carriers. We are moving from a two-ocean Navy now to a three-ocean Navy. The Navy people are up here saying we need more aircraft carriers to carry out our mission in the Pacific, and the Atlantic, and now in the Persian Gulf-Indian Ocean area.

It appears to me that there would not be anything wrong, or even unconstitutional, for the Japanese to help pay for some of these vessels, even if they were manned by American seamen, and there were no Japanese afloat on them.

Secretary SHULTZ. They, in effect, are paying, and we have been urging them to do more, which is, I think what you are suggesting. But they have been paying for U.S. bases in Japan, and giving support of that nature.

As far as the building of military equipment, for use by the United States is concerned, that is a novel idea. I do not know whether that carrier should be built in Yokohama or Newport News, or whether we should share all of that technology.

We do see emerging a good, I think, approach to military technological exchange with the Japanese, and I think that that can be constructive. That was one of the things that Prime Minister Nakasone ran into some flack on, that he proposed that, and will carry it through.

So I think in that relationship there is room for them to do more, and at the same time I am encouraged that the new Japanese Government is looking at these things very hard.

Senator SASSER. Thank you, Mr. Secretary.

Senator KASSEBAUM. Senator Chiles, you must get A for patience.

RESTRICTIONS LESSEN ON NONTARIFF TRADE BARRIERS

Senator CHILES. Mr. Secretary, the so-called nontariff trade barriers, those raised by the Japanese, have been costly and discriminatory toward U.S. companies. The French seem to have had some success, quite a bit of success, with their sending a message to the Japanese by the channeling of all their videotape recorders through the town of Poitiers.

I also understand that the Japanese agreed to lessen those types of restrictions through the EEC. How much success have we had?

I notice that you finally got some little breakthrough. Do you think we have had sufficient success, or are we going to have to send a message like the French?

Secretary SHULTZ. We have been sending messages, and I think we have seen successful efforts on the part of the Japanese to open up their markets. There are plenty of problems remaining.

To a certain extent, the most difficult problems go to the way that they administer the process of something coming into the country. We expect the registration in all of those letters, and they have been getting attention. How it will all come out, we are watching carefully, but it was a point of some encouragement to me when I was in Japan, 2 or 3 weeks ago, to hear the way the Prime Minister, the Foreign Minister, the Director of MEDA, were talking about their efforts, they were talking in the operative terms, not simply saying that their policy has changed from this to this, but to say I am asking for reports on precisely how the procedures have been changed, and so on.

In other words, they have the idea that you have to get down into the actual way things are being implemented to get anywhere, and I think that is encouraging, but we need to keep the pressure on, that we are.

TECHNOLOGY RESTRICTIONS

Senator CHILES. Good. In spite of our proclaimed U.S.-European agreement to tighten technology transfer to European bloc countries in the wake of lifting the pipeline sanctions, the message that I got from Europe and Germany during the recent trip I had, was not very reassuring. They were complaining that the U.S. propensity to restrict broad areas of technology, which was detrimental to their trade, to their industries, was not focused on the most critical technologies which have to be denied the Soviets.

I know that is subject to a part of a study that you are coordinating. When can we expect some kind of a result from those studies, and do you think that we can get on kind of a common set of definitions and procedures that can adequately monitor the transfer?

Secretary SHULTZ. Well, there are a variety of things going on, Senator. There are a number of studies. There is also an action program, you might say, in the form of the Cocom operations, and there the products to be restricted are surveyed, and an effort is being made to improve the substance of that organization so that it can act more promptly and definitively.

And that is a very important matter, and I would guess, from the comments you made, that that is probably the area where those comments were focused on, and my impression is that the discussions there are going quite well, and that with all of the controversy over the pipeline, sanctions and all, perhaps it has served to emphasize the people on how important the problem is, and how necessary it is to do something about it.

So I think we will come out with a strengthened Cocom list, and a strengthened procedure, and are in the process of doing that.

As far as the other studies are concerned, they are paced along each in its own terms. The credit is a very difficult subject to grapple with intellectually, but it is being tackled.

The subject of energy supply and demand is being worked on. I expect that probably by the time the OECD ministerial meetings come up in early May, and the Williamsburg Summit, the following North American ministerial meeting comes up in June, then during the course of those meetings that we will be able to get a reading on just how these studies are doing, and some of them may have some definitive results by that time.

But the process is working, along with goodwill, good intentions, and a lot of subjects.

EX-IM LEVELS INCREASED

Senator CHILES. I note that we are paying a little—some additional attention to the Eximbank situation. Do you feel that—and is the administration now committed to being able to put sufficient funds into Ex-Im? Are we going to show these other countries that we are going to be able to, and have the will to compete with them, when they go in and subsidize exports to the extent that they are prohibiting the competitive process?

Secretary SHULTZ. Well, the President's budget does increase the Ex-Im levels somewhat, and for the reason that you mentioned, export subsidy awards, whatever it feels, personally I feel are less losers, however, it is a question of when the rest of the world is mad you have to be sane to compete.

So we will compete, but I think that we can find reasonable agreements to withhold, not to engage this subsidy, we will be better off.

Senator CHILES. I think we definitely will be. But until we can prove that we will take our hands to the poker table, and are willing to compete, they are going to continue to kick our brains out, as they have been.

Secretary SHULTZ. I agree.

Senator CHILES. Thank you.

Senator KASSEBAUM. Thank you very much, Mr. Secretary. I appreciate your spending the morning with us.

[Whereupon, at 12:55 p.m., the committee adjourned, subject to the call of the Chair.]

NAM
National Association of Manufacturers

LAWRENCE A. FOX
Vice President and Manager
International Economic Affairs Department

March 17, 1983

The Honorable Pete V. Domenici
Chairman
Senate Budget Committee
425-D Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

An important budgetary decision is about to be taken by you and your fellow members on the Senate Budget Committee concerning the Export-Import Bank.

NAM has consistently supported a vigorous, hard-hitting export expansion program. This requires adequate funding of the Export-Import Bank so that it can provide export credit on competitive terms with that available to foreign competitors. We believe the Administration's proposed F.Y. 1984 funding package--$6.5 billion in direct loan authority and $10 billion in loan guarantee authority--is a major improvement over F.Y. 1983, and we wholeheartedly support the over-all proposal. However, we do not favor the Administration's plan to divide the direct loan authorization and appropriation into two parts: $3.83 billion to be made available in the normal manner and $2.67 billion by supplemental authorization and appropriation. We urge that the full authorization and appropriation be approved at this time.

If the Eximbank had the full $6.5 billion to work with from the beginning, the funds could be used with maximum effectiveness. Business requires assurance that loans will be available as needed in making commitments for foreign sales. Studies by the Office of the United States Trade Representative, the Department of Commerce, and the Eximbank, have documented a loan demand in F.Y. 1984 for Eximbank direct credit which will easily exceed the $6.5 billion authorization level. Considering the difficulty involved in going back to Congress for supplemental funds half-way through the fiscal year, there appears to be no logical reason for the two-step approach. Eximbank's record of great care in making loans is good assurance that funds will not be used if not needed. This, taken with the great possibility that the second step of the two-step process will not take place in time to be useful in F.Y. 1984, makes a very persuasive case for a simple full authorization from the very start of the fiscal year. Bi-partisan support for the one-step approach has been promoted by Congressmen Bonker and AuCoin in their joint letter to the Speaker of the House.

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Official U.S. export financing through the Export-Import Bank, has an important role to play in improving the competitiveness of U.S. manufactured goods, in particular of capital goods and other big ticket items. Although most U.S. manufactured exports are sold without Eximbank assistance, the Export-Import Bank has been the principal means of financing exports in a broad range of U.S. manufactured products for almost forty years. In 1982, for example, Eximbank financing generated over $18 billion in U.S. exports. At 25,000 jobs per $1 billion worth of exports, Eximbank, alone, supported over 450,000 American jobs. An improvement in the U.S. competitiveness of manufactured goods, in particular in the next few years, means more jobs in an economy that may be plagued with low growth throughout the 1980s. A recent Census Bureau report states that in 1977-80 nearly 30 percent of the net increase in private sector employment was due to manufactured exports. In 1980, 4.8 million jobs were related to the export of manufactured products, 1.5 million more than in 1977, and 79% of all new manufacturing jobs in that period were export related. On the other hand, thousands of American jobs in individual industries have been lost due to increased import penetration and the loss of world market shares by U.S. exports.

Due to inadequate appropriations, however, the Eximbank has not yet realized its full potential. Limited resources have meant that the bank is not competitive with foreign official export credit programs in Europe and Japan, for example. A major reason for the insufficient funding of the Eximbank by Congress is a lack of knowledge of the limited impact of the Bank's budget authority on the Federal Budget. The enclosed NAM Issue Brief explains the Bank's budget and its impact. Chart 2, for instance, shows that since 1977, total Exim program authorizations of $57.2 billion required net outlays of only $5.44 billion.

The uncompetitiveness of the Eximbank's program has, in the past two years, cost U.S. exporters millions of dollars worth of sales and thousands of jobs, as was brought out in testimony before the Senate Banking Committee in September 1982. Full appropriations for the Bank will help remedy the disadvantage American exporters face as a result of inadequate export financing.

We note that the President, in his 1983 State of the Union Address, indicated his intention to rectify past underfunding of the Bank and stated that "...we must have adequate export financing to sell American products overseas..." We believe the F.Y. 1984 budget makes an excellent step in this direction.

In light of the impact the exports financed by Exim programs could have on the U.S. economy and U.S. employment, we strongly urge you to support a stronger Eximbank budget as a cost-effective way to help put the American economy back on track.

I would greatly appreciate it if you could make this letter a part of the record of the Committee's hearings.

Sincerely,

Lawrence A Fox

Lawrence A. Fox

Enclosure

Issue Brief

A public policy summary

Export-Import Bank Reauthorization in 1983

Issue

The Congress must act by September 30, 1983, to reauthorize the Export-Import Bank of the United States. The bank, which provides financial assistance to American exporters through a variety of loan, guarantee and insurance programs, is critical to any U.S. export expansion policy. In recent years, however, U.S. manufacturers with superior products and competitive pricing have lost sales due to inadequate export financing.

What is disturbing about the poor competitive position of the Export-Import Bank is that U.S. trade problems can only be solved over the next decade by increasing exports of precisely those manufactured goods that need the support of an official export financing system. The realities of the world marketplace require exporters of capital goods and other manufactured equipment to put together the financing package for their customers. Whether the final price is competitive often depends on the export financing arrangements available.

Our industrial competitors have consistently regarded exports as a critical element of their overall economic policy, with government financing an essential ingredient in promoting export expansion. In the past few years Japan, the United Kingdom and Germany have supported over six times the percentage of exports than has the United States. These nations, as well as many others, are fully committed to expanding exports through official export financing. Since this commitment will certainly continue during the 1980s, the United States must address this challenge and begin to strengthen its export financing system.

■ *Small- and Medium-Sized Exporters.* While U.S. exporters, in general, have been hurt by the Eximbank's less-than-competitive programs, those who face the most difficult situation of all may be small- and medium-sized exporters who are trying to arrange competitive medium-term financing (e.g. 2-5 years, under $2.5 million). Despite a recent decline in interest rates, the Exim medium-term financing program is still not competitive with those of our major trade partners.

Two examples of policies contributing to the uncompetitiveness of Eximbank's medium-term as well as long-term programs are 1) the one-time "up-front" 2 percent fee Eximbank charges for credit applications; and 2) only allowing a maximum of 65 percent of the value of U.S. exports to be covered by direct credits while foreign competitors provide 80 to 85 percent coverage.

In addition, the bank's program has very limited funds with which to support U.S. manufacturers in sales of less than $5 million. Such limited funding has resulted in Exim financing that is "far inferior" to that of our major competitors, according to a recent George Washington University study.

The principal findings of this study, covering six case studies, indicated shortcomings of a considerable magnitude in Eximbank programs. The firms that were studied were all losing "the competitive battle" because foreign firms were able to get financing as low as 6.5 to 7.5 percent in 1981 and 1982. The resulting loss of exports can be expected to cause at least "a reduction of employment in the small to medium sized-firms and at worst, the demise of superior companies that are producing superior products in the United States."

The Eximbank initiated two new programs in October 1982 to help increase the bank's competitiveness. These new programs are the Small Manufacturers Discount Loan Program for companies which, together with all affiliates, subsidiaries and parent companies, had total gross annual sales of $25 million or less in the previous fiscal year and a new medium-term credit program which provides fixed interest rate support for medium-term export sales which face subsidized officially supported export credit competition from abroad. Small and medium-sized exporters contend that these programs are still not competitive.

☐ *Exim Budget.* One of the reasons the U.S. export financing system—medium- and long-term—is so uncompetitive is a misunderstanding about the cost to the U.S. taxpayer of providing adequate funding for the Eximbank.

The Eximbank receives no tax dollars from the U.S. Congress to cover the loans and guarantees it makes or the costs incurred in implementing its programs. Instead of appropriating funds for the Eximbank, Congress establishes a ceiling on the level of program activity that the Bank may engage in for each fiscal year. The bank then borrows the necessary funds from the Federal Financing Bank (FFB), an agency of the U.S. Treasury. All banks, whether commercial institutions or official government agencies, borrow in the credit markets to obtain the reserves necessary to provide loans to customers. In Eximbank's case, it borrows indirectly from the credit markets through the FFB (which borrows in the capital markets for several federal government agencies).

The Eximbank generates resources to repay its borrowings through loan repayments, interest on outstanding loans, commitment fees and insurance premiums. So far the bank has been able to absorb the cost of its borrowings, repay the FFB with interest, pay the Treasury Department more than $1 billion in dividends and triple its initial capitalization of $1 billion. In short, the Eximbank operates similarly to a commercial bank. It makes loans and charges interest and fees for services. As the loans are repaid and fees collected, the bank repays its own borrowings and the interest due on these borrowings, pays administrative costs and dividends and builds up reserves. Although each year Congress sets a limit on the amount of loans and guarantees that the Eximbank is allowed to issue, net outlays by the bank for its programs are much lower than the authorization figures. There are two reasons for this discrepancy.

First, there is no budget outlay for guarantee and insurance programs, which account for well over half of the annual authorization for the Eximbank, unless a claim is made against the bank. In the bank's almost 50 years of existence, the default rate on its guarantee program has been only three-tenths of 1 per cent of all guarantees issued.

Second, authorizations are made annually while outlays flow from these authorizations over a period of years. Thus, while the direct and discount loan programs are included at full value in the budget authority figures and the bank usually authorizes up to its limit, net outlays (what must be financed by borrowing from the FFB) are much smaller. To measure actual outlays, the schedule of disbursements must be taken into account, with loan repayments and interest payments subtracted from total expenditures.

Chart 1 illustrates how this process works using FY 1982 as an example. Prior year commitments on direct loans payable in FY 82 of $2.07 billion, current and prior year authorizations for discount loans of $.23 billion, and disbursements on new direct loans of $.28 billion required total loan disbursements of $2.58 billion. Operating costs, interest payments, administrative costs and net claims paid out were $1.72 billion.

These obligations were offset by $1.73 billion in loan principal repayments, $1.36 billion in interest charges and $40 million in guarantee insurance premiums and fees. Total disbursements and costs, less offsetting payments, equaled net outlays of $1.17 billion. So in fiscal year 1981, only $1.17 billion out of authorizations of $9.4 billion was borrowed from the FFB to implement Eximbank's program for that year. Thus the Eximbank's impact on the credit markets is marginal.

A summary of Eximbank net outlays for fiscal years 1977 through 1982 is found in chart 2. As the chart indicates, from 1977 through 1982 total program authorizations of $57.2 billion required net outlays of $5.44 billion.

Chart 1

Eximbank Impact on FY 82 Federal Budget in $ billion

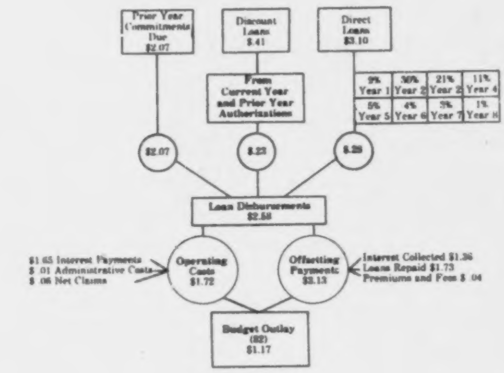

Chart 2

Eximbank Export Support and Its Impact on the Federal Budget (in $ billion)

	1977	1978	1979	1980	1981	1982	Total
Total Program Authorization (includes all loans guarantees and insurance)	5.6	7.4	9.5	12.5	12.8	9.4	57.2
Net Outlays	.3	(.1)	.2	1.8	2.07	1.17	5.44

NAM Position

In the debate over Eximbank reauthorization in 1983, it is important to eliminate confusion over the impact the authorizations for the bank actually have on the federal budget. NAM endorses President Reagan's statement in the 1983 State of the Union Address that "we must have adequate export financing to sell American products overseas . ." The achievement of this goal could be simplified and perhaps accelerated by certain changes in the Eximbank charter to be made during the 1983 reauthorization process. These changes include those listed below.

1. Language should be adopted that ensures adequate, regular funding of the Eximbank to meet the expanded growth of U.S. based exports in an increasingly competitive world market.
2. The congressional mandate that the bank provide competitive export credit programs in both the medium- and long-term areas should be clarified.
3. A "warchest" should be established using special appropriated funds to counter "predatory financing" by foreign governments which are contrary to OECD guidelines.
4. The U.S. government should press for international agreement on cessation of subsidy credits for exports.

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March 1983

ECONOMICS

THURSDAY, FEBRUARY 24, 1983

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee convened, pursuant to notice, at 10:05 a.m., in room 6202, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Armstrong, Hatch, Symms, Grassley, Quayle, Gorton, Chiles, Biden, Sasser, Metzenbaum, Riegle, and Exon.

Staff present: Stephen Bell, staff director; Gail Fosler, chief economist; Richard N. Brandon, minority staff director; and Kemble Stokes, chief economist for the minority.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman DOMENICI. The hearing will please come to order.

Mr. Chairman, it is a pleasure to welcome you once again to the Senate Budget Committee. As you probably already know, this committee intends to move forward quickly, perhaps as soon as March 7, to begin the development of a budget resolution. This year's resolution will require decisions that are just as difficult as those we have made during the past 2 years, when we have had rather significant budget restraint.

TIME OF DISAPPOINTMENT AND DOUBT

For this reason, I would like to address a theme that you set in your testimony before the Senate Banking Committee last week, that this is a time of disappointment and doubt as well as potential promise. This is not only a time of disappointment and doubt for many Americans who have suffered as a result of 4 long years without any economic growth in this country. This is also a time of disappointment and doubt for many here in Congress, who have supported some very difficult fiscal decisions with very little evidence of tangible economic results. This is not a process that can go on indefinitely, and certainly, as it pertains to this committee, it gets more difficult with each year.

Last year, the committee recommended $418 billion in deficit-reducing actions over the 3 years, fiscal year 1983 through fiscal year 1985. The Congress enacted into law $128.8 billion in spending reductions and tax increases under the procedure we call reconciliation.

We did this, Chairman Volcker, because we thought interest rates would go down, not just the interest rates that the Treasury pays, but interest rates for the average American. With lower interest rates and a smaller Federal deficit, the economy would recover. Stable, long-term economic growth would expand employment opportunities for all Americans, including those who lost some special benefit as a result of our actions. This was our hope, and this was our expectation.

You appeared before this committee on July 28 of last year. The unemployment rate was 9.7 percent. Treasury bills were about 12 percent, and the prime rate was about 15 percent. At that time, it was my position, at least the judgment of this Senator, that if these expectations were not realized in some reasonable timeframe, then I thought we stood to lose much of what we had gained in terms of fiscal responsibility during the past 2 years. I think we see some of the signs of that developing now.

I have not changed my views. Interest rates are lower for some borrowers, principally the Treasury, but they are still very high for the average borrower. Treasury rates may even be headed up. Unemployment is near 10½ percent, and while it has begun to drop, it is at an extremely high level and has been there for an extremely long time.

As one who has been on this committee and taken every effort I could as its chairman, these are very disappointing results when you consider the efforts that we went through last year. But, Mr. Chairman, still more disappointing is the continued explosion of budget deficits, despite fiscal restraint.

Clearly, Congress has much to do to reduce deficits over the long run. I am certain that this committee will try to do what it can, as soon as possible, to again recommend major policy actions to bring these deficits down. But I cannot help but look at these large deficits and ask what has been the role of monetary policy in this.

SOURCES OF INCREASES IN BUDGET DEFICITS

I was struck by the CBO's annual report, released earlier this month. There is a table in that report that I find rather telling. This table shows the sources of the increases in the budget deficits since 1981. Over the 5-year period 1982 through 1986, 31 percent of the increase in these deficits is due to legislation. This means tax cuts, defense spending increases, and of course, the failure of Congress to fully offset the effects of the measures that I have just enumerated with equal cuts in nondefense spending.

But I remind you that their conclusion is that that is only 31 percent of the increase in the deficit. This is the congressional problem. I have not studied their evaluation in detail, but I think I would draw the rather simple conclusion that the congressional problem is 31 percent of the problem. This is, as I view it, what we have begun to call the "structural" deficit that everyone is talking about. This is the focus of the budget decisions that this committee will face in the next few weeks.

But that CBO report also shows that 69 percent of the increase in deficits is due to a weaker economy caused by higher interest rates and something called technical estimates, which may be a lot of little things, but I understand it is mostly farm prices, from what I can abstract from their reasoning.

This, to my mind, yields the following—that these are results of monetary policy, not fiscal policy. How can fiscal policy do its job, when the baseline deficits are increasing as a result of monetary policy, just as fast as we are putting policy changes into place? Is it possible that monetary policy, not fiscal policy, guides the economy at least in the very short term? Now, I am not necessarily agreeing with what you have said in the past, and I will repeat that statement. Again, is it possible that it is monetary policy, not fiscal policy, that guides the economy at least in the very short term?

Is the Congress therefore a "policy taker" and not a "policy maker" in that respect?

We hear a great deal about Treasury borrowing placing pressure on interest rates. If this table is to be believed, 84 percent of the higher deficit this year, that is, the expectation of higher than we planned in 1981, is due to the economy and not to actual legislated policy. I find it ironic that we are told that the expectation of large deficits yields high interest rates, when in fact, it has been high interest rates that have yielded large deficits, at least to the extent of the analysis that I have just given you.

CUT SPENDING AND RAISE TAXES TO REDUCE DEFICITS

I believe that we have to cut spending and undoubtedly, raise taxes, to reduce future budget deficits. I have not departed from that. I think we did our share last year in both respects. It is essential for sustained economic growth both here and abroad that we do that, and it is essential for maintaining our hard-won inflation gains. It is essential for private business investment. But this Senator wonders—and I can assure you, I am committed to these goals—but I wonder if we are not in more of a "catch-22" than we had thought.

Your recent testimony is clear on one point. We are faced with grave domestic risks from the weakness of economies abroad. We cannot take risks, and we must be prudent. Therefore, I would hope that if Congress acts to get its fiscal house in order, the Federal Reserve would continue to pursue a strong growth-oriented monetary policy, one which would be sensitive to the devastating effects of monetary policy on the very size of the budget and the deficit problems.

As always, you know, Mr. Chairman, you are here in difficult times. It seems you have not been before us when we were not in those difficult times. But we will achieve a sustained recovery only if we are realistic about the opportunities and the limits of fiscal policy and Congress ability to respond and the limits of monetary policy, as we currently understand them and as we set policy goals which will achieve them.

I very much appreciate your appearing again. We will have a number of questions, I am sure, from a number of Senators, and I would like now to yield to Senator Chiles.

OPENING STATEMENT OF SENATOR CHILES

Senator CHILES. Thank you, Mr. Chairman.

Mr. Volcker, we are pleased to have you with us this morning.

Few people in this administration have been as firm as you in insisting that the Federal deficits must be cut before we can look forward to a durable recovery. I can imagine that you must have been a little disappointed by the numbers in this year's budget, showing not only that those deficits are still high, but that they are expected to remain that way for years to come.

It does not seem to me that the administration is doing enough to tackle those deficits, and all you have to do to confirm that is look at the deficit numbers for the next several years.

The 1984 deficit will be $189 billion, and according to the administration's own estimates, it will be $194 billion in 1985. Two years, and no great cut in the deficit. That is not progress. When the Congressional Budget Office tells us that the 1988 deficit will still be around $160 billion, that is not progress either.

Yet, the White House seems inclined to wait around for recovery. The only major revenue proposal they offer will not take effect until 1986, and only then if the deficit is above 2.5 percent of the gross national product.

TAX INDEXING

Prior to 1986, the administration will not budget on revenues, and the White House says they will not even give up on tax indexing, even though a number of my colleagues on the opposite side of this table say the President should do just that.

I certainly say that doing away with indexing would be fine, or delaying it, but it does not amount to that much if that is all you are willing to do. If you stop indexing, all you save is $6 billion in 1985, and the serious savings from a repeal of indexing comes in the out years, 1987 and 1988. I am for delaying the provision, but even then, the repeal of indexing only raises revenues by eight-tenths of 1 percent, far out-of-scale with the 5.6 percent of the GNP deficit that we start with.

For the near term, for the time between now and 1985, I think we have got to do a lot more.

TAX CUTS

Just about everyone you talk to at the White House says the same thing about the third year of the tax cut. Everyone over there says that we need the stimulus. Everyone says with recovery bobbing in the water, this is not the time to cut bait and raise taxes. That sounds a little fishy to me.

We are not talking about raising taxes. We are talking about not cutting them any further in the face of big deficits. I will be interested in hearing your answer to the question I have asked Dr. Feldstein and that is, if the third year of the tax cut was not already on the books, would you suggest that we cut taxes further now?

Dr. Feldstein said he felt that was too hypothetical a question for him to be able to answer.

You oversee the credit markets, Mr. Chairman. Wouldn't it be easier for you and for the interest rates if we brought the deficit down another $40 to $50 billion in 1985? I think the answer to that is clear. In fact, it is as clear as what the reaction of the credit markets is likely to be in the future years if we still have huge deficits while the economy is growing. That is just what the administration foresees, but they do not seem to understand what a big problem it is.

Whatever your opinion on that question, the fact remains that the main issue is not short-term stimulus. When you add the three tax cuts together, you wind up with a permanent 25-percent drop in the tax base. That is not 25 percent worth of short-term stimulus; that is 25 percent worth of permanent baggage that will weigh down every effort we make to try to cut Federal deficits.

INTEREST RATES

As long as these deficits remain so high, and the tax cut all but guarantees that they will remain high, the threat of high interest rates is going to remain serious.

It seems to me that between a White House economic policy determined to slash revenues and a Federal Reserve policy to keep monetary policy so tight, so long, the depth of the recession should have come as a surprise to no one.

You said last week that you did not see the Federal Reserve bending any further on interest rates. That, of course, raises serious questions. After a decline through a good part of the second half of last year, we saw those rates inch back up in December and July, as the markets started to see the deficits were not getting smaller. If you are not going to bend on monetary policy, and the President is not going to bend on economic policy, I get pretty worried about where we are going.

It comes down to this, Mr. Chairman. The administration has seen the light, or there seems to be some evidence of that, but the people have been more realistic to the extent that they see some changes in their game plan are necessary. They do not see those changes coming about, though, until around 1986, when they begin to do something about it.

It is hard to chart the waters. It has always been hard. But there is plenty that must be done. I think we have to take forceful steps here in the Congress to fight that deficit, but we also need to know what the Federal Reserve will do. We need to know what forceful steps the Federal Reserve will take to get those real interest rates down below the 5 to 6 percent of real interest where they are now, and we certainly need some joint action to restore our economy, and I look forward to your testimony this morning.

Chairman Domenici. Mr. Chairman, you may proceed. We have your written testimony. If you desire to read it, you may, and it will be made a part of the record.

STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. Volcker. Let me try to summarize part of it, Mr. Chairman. Let me say, first of all, as you indicated, you are in a most difficult position on this committee. Nobody envies you your job. But I think that job is absolutely critical to the future of our economy, and I have very considerable confidence in this committee, its role, and its members, in that respect.

You expressed some disappointment over the results of your actions last summer. Let me say we can all be disappointed that it turns out, 6 months later, that the deficit figures look even larger; I understand that very well. But I also would point out that I think there was some encouragement taken from your actions last summer. Interest rates have certainly come down sharply since that time. You are dealing with an even more severe situation in the budgetary sense than you thought then, so the challenge remains; in some respects, it is even larger. But I can only say the situation would even be worse, and the economy would be in worse shape, if you had not taken the actions you took last summer.

You and Senator Chiles have gotten into some other specific questions that I am sure will come up later.

CURRENT ECONOMIC CONDITIONS

In my statement, I review current economic conditions which, of course, are characterized recently by some signs that not only recessionary forces are ebbing, but by clear evidence that activity is turning up in some sectors. It remains to be seen how much carrying-throuqh power that has, but the latest evidence is certainly on the favorable side, led by areas of the economy that are particularly sensitive to credit conditions, like housing and to some extent automobiles, both of which have recovered from what had been extremely low levels. Other sectors of the economy such as business investment and exports, I think, continue on the weaker side, so you have offsetting changes. After some very large inventory liquidation in the fourth quarter——

Chairman DOMENICI. Mr. Chairman, would you pull that mike up closer? They are having difficulty hearing.

Mr. VOLCKER. After some large inventory liquidation in the fourth quarter, we are seeing production increases, and if final demand does continue to rise, we can expect production to increase, perhaps more than proportionately because of the inventory situation.

OUTLOOK FOR INFLATION AND INTEREST RATES

The other part of economic developments that has clearly been on the plus side is the sharp decline in inflation rates over the past year, with all the indices at 5 percent or less last year. My statement suggests not that the inflation problem is over by any means—it is still at a level we thought of as a crisis level a decade ago—but that there are forces at work that are very promising in terms of sustaining that progress on inflation. I think that is absolutely critical to the interest rate outlook, that we do sustain the progress on inflation, and I review some of the evidence in that respect. I certainly feel somewhat more optimistic and I think most of my colleagues in the Federal Reserve feel somewhat more optimistic about the near-term inflation outlook than either the administration or, to some extent, the CBO, in their own projections. But I do not delude myself into thinking that that problem is gone; after 10 years of growing accustomed to inflation and to fear of accelerating inflation, an enormous amount of skepticism remains, not just in financial markets but with the public at-large, that those gains will not carry through. That has very great implications both for monetary policy and for budgetary policy as far as creating the kind of environment and confidence that those gains will continue; among other things, it is so fundamental to the interest rate outlook, and the interest rate outlook, of course, in turn is an important factor in sustaining recovery.

INTERNATIONAL CONSIDERATIONS

I touch upon international considerations in my statement. I point out that in terms of the very difficult international situation, I think a strengthening of the resources of the IMF is absolutely critical. Your committee presumably will have to—I would urge you to—make allowance for that in your budgetary resolution.

MONETARY POLICY IN 1983

I will begin reading on page 7 where I discuss monetary policy specifically. Note that the American public reached the stage in the midsixties that it felt quite confident about the ability of the Government to keep the economy on a stable growth path, in the terms of the day to "fine tune" the economy. But since the midsixties, long years of accelerating inflation and rising unemployment, instability in financial markets and the economy, and concern about continual budget deficits have eroded that confidence. I believe we can restore it—not in the earlier sense that a high degree of fine-tuning is thought to be feasible, but in the sense that Government can encourage a sense of price and financial stability and a fundamental environment for growth.

In one important sense—dealing with inflation—we have come a long way in the past 2 years, even though a good deal of skepticism remains and we must not assume the battle is over. That effort has been accompanied by strains and tensions in financial markets at home and abroad, extraordinarily high interest rates, and, of course, a serious recession. But now we can also begin to see prospects for recovery and more settled conditions in financial markets. Changes in the fiscal structure adopted in recent years should, in time, help encourage investment and savings.

But there are also obstacles that must be removed if we are to capitalize on the progress that has been made and to make the happier vision a reality. Both monetary and fiscal policy will have large and complementary roles to play in dealing with those obstacles and providing a solid base for renewed confidence.

The role of monetary policy is to build on the progress against inflation while providing enough money and liquidity to meet the needs of recovery.

In some respects, the line is a narrow one, and it can't be determined with mathematical precision. But in approaching our policy decisions, two things are clear. First, renewed inflation—or policies that seem likely to lead to that result—is neither a satisfactory nor a practical option. The sensitivity of the public and the markets to signs of renewed inflation are all too likely to produce precisely the reactions in financial markets—and in wage bargaining and pricing policies—that would soon weaken or abort recovery. The result would be a replay of the past decade or worse.

Second, the problems for monetary policy in meeting the needs of the economy are vastly complicated by the present prospect that huge Federal deficits will preempt so much of our credit and savings as a recovery proceeds. I spoke a moment ago of the narrow path for monetary policy, but I must also emphasize there is no path that can resolve the economic and financial effects of excessive deficits in a growing economy. The present budgetary outlook—until corrected—can only maintain skepticism about future prices and interest rates, narrowing the flexibility for monetary policy now.

I reported in detail on the specifics of monetary policy with respect to our various monetary and credit aggregates last week, and that material has been made available to you with this statement. I would only note now that the relationships between money and economic activity did not follow normal cyclical and trend patterns last year, partly because of the introduction of new deposit accounts but also because of broader economic reasons. Demands for money and liquidity appeared to be enlarged by the uncertainty of individuals and businesses abut the economy and financial developments. There is also the possibility that the combination of declining inflation, lower market interest rates, and the increasingly common practice of paying interest on transactions accounts may have a lasting impact on trends in velocity and, therefore, on the appropriate supply of money over time.

Looking through all the complications and taking account of institutional distortions, our targets for money and credit growth in 1983 are similar to those in 1982. Because actual growth last year generally exceeded the target ranges, the effective growth this year should be less than in 1982. Based on present evidence and allowing to some degree for usual cyclical patterns, that amount of liquidity should be fully consistent with the anticipated growth in the economy and sustaining the progress against inflation—consistent, in fact, with the kind of projections you have from the administration and the Congressional Budget Office. In a context of declining inflation, the monetary targets themselves are not inconsistent with further reductions in interest rates—but I must add that other factors, including the budget deficit, impinge strongly on interest rate levels.

The variety of monetary indicators we use and the rapidity of institutional change are potentially confusing. In the circumstances, there is an understandable yearning by some to encompass all policy considerations in a simple, relatively rigid rule. But I know of no such rule reliably suited to our present circumstances. Elements of judgment seem to me inevitable in interpreting the data, and the targets will need to be judged and reviewed at suitable intervals in the light of developments with respect to economic activity and prices and conditions in the domestic and international financial markets. At the same time, the targets do provide a needed discipline, and we mean to be within them over relevant spans of time. They will be changed only if evidence for such change is strongly persuasive.

We do take as a point of departure in our judgments the critical importance of maintaining the momentum against inflation. In fact, most members of the Federal Open Market Committee believe that, taking the broader price indices, the inflation outcome in 1983 is likely to be better than projected by either the administration or the Congressional Budget Office. The recent developments with respect to oil prices only reinforce that outlook. Given the supply of money and credit, such an inflation outlook implies lower interest rates than otherwise and more room for real growth.

THE FEDERAL BUDGET AND MONETARY POLICY

The most obvious obstacle to sustained recovery is the prospect of huge Federal deficits even as the economy expands. In the last fiscal year, the Federal deficit was a record $111 billion. The President's new budget report projects a deficit in the current fiscal year nearly double last year's figure and further growth into the foreseeable future in the absence of determined action to alter that outlook.

The members of this committee of course, are well aware of the enormity of these projected deficits, but there may be a danger that numbers in the $200 billion plus range have been cited so frequently as to make them seem almost comfortable and familiar No matter how readily $200 billion slips off the tongue, the hard fact remains that deficits of that magnitude would preempt an unprecedented share of our net savings, keep real interest rates high, and divert funds from the investment and the housing we need and want.

To be sure, a substantial part of the current deficit—projected at about 6½ percent of the GNP—reflects the impact of the recession on the budget. Slack economic activity and higher unemployment have cut deeply into revenues and boosted outlays for unemployment benefits and other automatic stabilizers. At a time when investment is weak and private credit demands have slackened, these cyclically induced deficits have helped support spendable income and buoy the economy. They have not, in the midst of deep recession, been inconsistent with declines in interest rates—but interest rates have, as you know, remained high relative to the current rate of inflation.

As the economy recovers, the cyclical portion of the deficit will recede. But as things now stand the deficit itself will not. Higher revenues from economic growth and reduced spending for unemployment compensation will be offset by—and possibly more than offset by—growth in other spending programs and the effects of earlier tax changes. In other words, through the mid- and late-1980's, a huge imbalance would remain even if the economy were operating at much lower levels of unemployment—and assuming inflation remains under control.

All that is familiar to you—and it is equally familiar to the finanical markets, where the prospect of a major structural imbalance in the Government's finances has an impact on current interest rates. It is not just the direct demand for funds to finance the Treasury that is of concern but the fear that ballooning Federal borrowing needs will, in effect, bring extraordinary pressure on the Federal Reserve to monetize the deficits, with implications for inflation itself, for inflation expectations, and for inflation premiums in nominal interest rates. One implication is that, to the extent the budget deficit appears to be intractable, the burden placed on monetary policy to demonstrate the Government's resolve to follow a noninflationary course is intensified. The converse is equally true: meaningful action to demonstrate the Government's economic discipline on the fiscal side would reinforce confidence that monetary policy over the years ahead can do its job in maintaining a course consistent with price stability without intolerable market pressures.

It is tempting for some to suggest that the budget problem and its consequences for the performance of the economy could be solved by monetary policy. But excessive money creation to meet the needs of the Government would only reinforce and validate the fears of renewed inflation, and sooner or later, higher interest rates. In the end, excessive monetary growth would put us in an even more unsatisfactory situation, with still more deeply ingrained inflation expectations and greater skepticism about the ability of our Nation to manage its economic affairs. Nothing real would be gained for long, and hard-won ground in the battle against inflation would be lost.

In concept, any inflationary impact from the budget can be contained by appropriate monetary policy. But the harsh implications of excessive deficits for other credit-dependent sectors of the economy would clearly remain.

I don't want to suggest there is a simple trade-off, as sometimes suggested, between future budget policy and current monetary policy. Reducing the threat of those large structural deficits stretching out to the end of the decade in and of itself should have favorable effects on current interest rates and in damping concerns about future increases. In that real sense, budgetary virtue will provide its own tangible reward.

But those benefits would ultimately be lost if monetary policy were to abandon its continuing and necessary concern with restoring reasonable price stability. That point remains central.

What can be said is that a better fiscal outlook, with all it implies, would certainly provide a better environment in the financial markets today, reduce concern about future inflation and an early rebound in interest rates, and moderate preoccupations that the Federal Reserve itself might somehow be forced to retreat from its basic anti-inflationary course. As things stand, with monetary policy assumed to be the only bulwark against renewed inflation and a high degree of sensitivity to the past failures in efforts to contain inflation, every twist and turn in the monetary aggregates or short-term policy actions interpreted as easing is closely scrutinized as a sign or symbol of intentions over a longer period. Clear progress in dealing with the budget could, in that sense, somewhat enhance our operating flexibility, so long as we succeed in reinforcing the basic point that the effort to sustain the progress against inflation is intact.

As you know better than I, the process to cut down those future deficits must start now, and with energy and force. Basic budget trends take time to change, but the knowledge that they will be changed will affect markets now. The amounts involved are large, but certainly not beyond our capacity.

It is obviously beyond my competence, or the province of the Federal Reserve, to deal with all the particular priorities that must be balanced. The administration has set forth its program in that respect. The general order of magnitude seems to me appropriate, although some of the measures proposed would, in my judgment, be more effective if brought forward in time. Others have proposed different specifics, and I am sure they will receive condideration.

From the standpoint of general economic policy, the more that can be done in restraining expenditures the better. You, of course, have to reconcile that with other priorities, and the basic point is that the sheer arithmetic of the problem does suggest that changes will be necessary over a broad range of programs—both on the spending and revenue side. I believe recognition of that fact is becoming increasingly widespread both in and out of Washington.

Your committee is in the critical position of converting that wide consensus on generalities into a specific program, and I have some idea how difficult that is. But I also have some idea how important it is to our future.

CONCLUSION

I need not dwell on the fact that we are negotiating a most difficult period in our Nation's economic history. But I also believe we are in the process of laying the base for more vigorous, and lasting, noninflationary growth. In looking to the rest of the decade and beyond, there are, in my view, strong forces at work that should lead to a kind of self-reinforcing process of growth, greater price stability, higher real income and profits and declining unemployemnt. But there are obstacles to that prospect. Monetary and fiscal policies alike need to be directed, and work in concert, toward removing those obstacles and achieving that bright promise.

Thank you, Mr. Chairman.

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on the Budget

United States Senate

February 24, 1983

I appreciate the opportunity to appear before this Committee today to discuss the current economic and budgetary situation and the Federal Reserve's goals for monetary policy. Last week I presented to the Banking Committees the specific numerical targets for the growth of money and credit in 1983 set by the Federal Open Market Committee (FOMC). This morning I will focus on the broad issues confronting monetary policy and their relationship to other aspects of domestic and international economic policy.

Current Economic Conditions

Recessionary forces were ebbing at the end of 1982, and activity has turned upward in several sectors. Moreover, we have made impressive progress against inflation over the past year, and the underlying trends of inflation point at least toward consolidating that progress in 1983, and more likely toward further improvement. Thus, the opportunity presents itself for an orderly recovery in business activity that will bring with it the increases in job opportunities and real income that we all desire. The challenge is to see the present signs of incipient recovery evolve into a long-lasting non-inflationary expansion.

A key element in the improved outlook is the change in financial market conditions over the past year. Short-term interest rates are now as much as 10 percentage points below their earlier peaks, while long-term rates are down about 4 to 5 percentage points. Reflecting these developments, activity has been improving in the credit-sensitive sectors of the economy.

The most notable turnaround has been in the housing market. Production and sales of new single-family homes have now risen substantially over the depressed levels of late 1981 and the first half of 1982. With personal debts relative to income lower than in several years and with liquid assets rising, activity in consumer markets also has shown some signs of improvement. Auto sales, in particular, have responded to the lower interest rates offered under special programs as well as to improvements in design and pricing policies that have made domestically produced autos more competitive and more attractive to consumers. Moreover, consumer purchases of other "big-ticket" items also appear to be improving.

As is usually the case, the inventory cycle has played a large role in the recession, and will determine the speed and shape of recovery in its early stages. Businesses made vigorous efforts to control the accumulation of unwanted stocks early in the recession and again in the final months of 1982 when recovery failed to develop, as had been widely anticipated, earlier in the year. Inventories generally are now back to the levels of early 1981. Consequently, if final sales continue to strengthen, increases in production could be more than proportionate

For the time being, with excess capacity large and profits depressed, business investment in new plant and equipment is likely to continue to fall. Some delay in the recovery of capital spending is not out of line with previous cyclical experience, as many firms initially intensify the use of existing capital rather than invest in new plant and equipment.

Nonetheless, there are some encouraging signs in this sector. In particular, new orders for capital goods have firmed in recent months. Moreover, lower costs for long-term borrowing and equity financing have allowed firms to begin restoring their balance sheets to more liquid conditions -- thereby putting the business sector on a sounder footing for expansion.

The U.S. economy has become increasingly integrated into the world economy over the years. In contrast to most earlier recessions, exports dropped sharply in 1982, reflecting both the recessionary tendencies in the rest of the world and substantial appreciation of the dollar in 1981 and much of 1982. The sluggishness of business activity abroad is a major reason that recovery here is likely to be significantly less rapid than after most previous recessions.

The Outlook for Inflation and Interest Rates

The outlook for a sustained expansion of economic activity depends in major part on the success of monetary and fiscal policies in fostering confidence in our ability to make continuing progress against inflation in the years ahead. Interest rates and inflation rates frequently do not bear a close relationship to each other for short time periods -- and those periods can sometimes extend over several years. Over time, however, there are strong analytic reasons to expect a closer relationship because borrowers and lenders alike are interested in real returns -- that is, in assessing the costs or returns of investments after allowance for changing prices. What counts, in that respect, is expected prices, which we cannot measure directly. To the extent that substantial doubts exist that the progress against inflation may not be maintained, interest rates currently -- particularly long-term rates -- will remain higher than otherwise necessary. That situation is further aggravated, as I will discuss in a few minutes, by the prospect of outsized federal budget deficits in future years. To the extent interest rates are an obstacle to sustained, well-balanced recovery and to improved economic performance generally, we must deal with these doubts and concerns.

Looking back, the gains in the fight against inflation are striking. All broad measures of prices rose less than 5 percent last year, the slowest rate of increase in a decade. To be sure, part of the improvement reflected unusually favorable food and energy price developments as well as abnormally low commodity prices, the effects of the sharp appreciation of the dollar, and more generally, the cyclical weakness of the economy.

Potentially more important, however, trends of underlying costs are now moving lower, and those trends should be sustainable as the economy recovers its upward momentum. One element suggesting optimism is the recent behavior of productivity. After languishing in the late 1970s and early 1980s, labor productivity turned up last year, somewhat unusual in the midst of recession. Beyond those statistics, which at this point can only be suggestive of a changing trend, there is increasing evidence of efforts by both workers and management under the pressures of competition and recession to increase efficiency and reduce "break-even" points. The fruits of those efforts should be more apparent during recovery. If combined with continuing moderation in nominal wages, the result should be long-lasting reductions in cost pressures and expansion of real incomes. Increases in nominal wages slowed to the 6 percent range last year, and seem to be rising at a slower pace than that now. That slowing of nominal wage increases has been fully consistent with rising real wages for those working because price increases have come down more rapidly than wages. With real wages rising, one source of pressure for aggressive wage bargaining should subside.

Clearly, the more restrained wage increases last year were directly related to the pressures in the labor market. Employment fell throughout 1982. Although layoffs were concentrated in the industrial sector of the economy, even the service-producing sector -- the primary source of employment growth in recent years -- experienced declining payrolls. The extent of these employment cutbacks was reflected in sharp increases in the unemployment rate. While the January drop in joblessness was encouraging, current unemployment rates are still obviously high, and may decline only slowly.

Success in dealing with inflation cannot be based on an economy that stays in recession, with unacceptable levels of unemployment. But we will need to maintain moderation in wage settlements and pricing policies as the economy expands. The favorable near-term outlook in that respect is reinforced by the current softness in the price of one of our most important raw materials -- oil. But sustained improvement will depend on a sense of conviction that government policy will remain alert and forceful in dealing with inflationary threats as the economy expands. That is the same environment in which interest rates can decline, and stay lower, helping to support a recovery in investment and sustained growth.

International Considerations

Other industrialized countries have been attempting to deal with some of the same basic problems that we have been facing. Most of them have been fighting stubborn inflationary pressures. Subnormal economic performance has been pervasive, and unemployment of labor and the underutilization of other resources have risen to levels unprecedented in the postwar period.

The sluggishness of activity in the advanced industrial economies has affected the volume of exports of developing countries and contributed to substantial declines in commodity prices. Those factors, in turn, have made it more difficult for some heavily indebted developing countries to deal with those debt burdens. Growing recognition of the potential strains on the international banking system -- after a decade of rapid growth in lending to developing countries -- was precipitated in part by interruptions in debt service by Mexico last summer.

One danger has been that lending banks would attempt to protect their individual positions by rapidly retreating from new lending. But borrowers who have built up large debts over a period of years are not in a position to repay suddenly. An uncoordinated attempt to force such repayment would undercut the stability of the borrowers, the lenders, and the international financial system alike. We could not fully insulate our domestic banking and credit system -- and our own economy -- from such developments. Consequently, we have the strongest kind of self-interest in measures to contain and deal with the threat.

Management of that situation has required, and will continue to require, the active cooperation of borrowing countries, banks, central banks and treasuries of leading countries, and international financial institutions. The International Monetary Fund has a special, and indispensable, role to play. In that connection, I believe it is essential that the Congress approve enlarging the resources of the IMF at an early date so that it can, with some assurance, proceed in the knowledge that its resources will be adequate to meet its responsibilities. As you know, that action will require budgetary authorization and appropriation, even though the operations of the IMF do not significantly affect net budget outlays or the deficit.

Monetary Policy in 1983

There was a time not so long ago when the American public felt confident -- in retrospect overly confident --

about the ability of government to keep the economy on a stable growth path. Since the mid-1960s, long years of accelerating inflation and rising unemployment, instability in financial markets and the economy, and concern about continual budget deficits have eroded that confidence. We can restore it -- not in the earlier sense that a high degree of "fine tuning" is thought to be feasible,but in the sense that government can encourage a sense of price and financial stability and a fundamental environment for growth.

In one important sense -- dealing with inflation -- we have come a long way in the past two years, even though a good deal of skepticism remains and we must not assume the battle is over. That effort has been accompanied by strains and tensions in financial markets at home and abroad, extraordinarily high interest rates, and, of course, a serious recession. But now we can also begin to see prospects for recovery and more settled conditions in financial markets. Changes in the fiscal structure adopted in recent years should, in time, help encourage investment and savings.

But there are also obstacles that must be removed if we are to capitalize on the progress that has been made and to make the happier vision a reality. Both monetary and fiscal policy will have large and complementary roles to play in dealing with those obstacles and providing a solid base for renewed confidence.

The role of monetary policy is to build on the progress against inflation while providing enough money and liquidity to meet the needs of recovery.

In some respects, the line is a narrow one, and it can't be determined with mathematical precision. But in approaching our policy decisions, two things are clear. First, renewed inflation -- or policies that seem likely to lead to that result -- is neither a satisfactory nor a practical option. The sensitivity of the public and the markets to signs of renewed inflation are all too likely to produce precisely the reactions in financial markets -- and in wage bargaining and pricing policies -- that would soon weaken or abort recovery. The result would be a replay of the past decade or worse.

Second, the problems for monetary policy in meeting the needs of the economy are vastly complicated by the present prospect that huge federal deficits will preempt so much of our credit and savings as a recovery proceeds. I spoke a moment ago of the "narrow path" for monetary policy, but I must also emphasize there is no path that can resolve the economic and financial effects of excessive deficits in a growing economy. The present budgetary outlook -- until corrected -- can only maintain skepticism about future prices and interest rates, narrowing the flexibility for monetary policy now.

I reported in detail on the specifics of monetary policy with respect to our various monetary and credit aggregates last week, and that material has been made available to you with this statement. I would only note now that the relationships between money and economic activity did not follow "normal" cyclical and trend patterns last year, partly because of the introduction of new deposit accounts but also because of broader economic reasons. Demands for money and liquidity appeared to be enlarged by the uncertainty of individuals and businesses about the economy and financial developments. There is also the possibility that the combination of declining inflation, lower market interest rates, and the increasingly common practice of paying interest on transactions accounts may have a lasting impact on trends in "velocity," and therefore on the appropriate supply of money over time.

Looking through all the complications and taking account of institutional distortions, our targets for money and credit growth in 1983 are similar to those in 1982. Because actual growth last year generally exceeded the target ranges, the effective growth this year should be less than in 1982. Based on present evidence and allowing to some degree for usual cyclical patterns, that amount of liquidity should be fully consistent with the anticipated growth in the economy and sustaining the progress against inflation -- consistent, in fact, with the kind of projections you have from the Administration and the Congressional Budget Office. In a context of declining inflation, the monetary targets themselves are not inconsistent with further reductions in interest rates -- but I must add that other factors, including the budget deficit, impinge strongly on interest rate levels.

The variety of monetary indicators we use and the rapidity of institutional change are potentially confusing. In the circumstances, there is an understandable yearning by some to encompass all policy considerations in a simple, relatively rigid rule. But I know of no such rule reliably suited to our present circumstances. Elements of judgment seem to me inevitable in interpreting the data, and the targets will need to be judged and reviewed at suitable intervals in the light of developments with respect to economic activity and prices and conditions in the domestic and international financial markets. At the same time, the targets do provide a needed discipline, and we mean to be within them over relevant spans of time. They will be changed only if evidence for such change is strongly persuasive.

We do take as a point of departure in our judgments the critical importance of maintaining the momentum against inflation. In fact, most members of the Federal Open Market Committee believe that, taking the broader price indices, the inflation outcome in 1983 is likely to be better than projected by either the Administration or the Congressional Budget Office. The recent developments with respect to oil prices only reinforce that outlook. Given the supply of money and credit, such an inflation outlook implies lower interest rates than otherwise and more room for real growth.

The Federal Budget and Monetary Policy

The most obvious obstacle to sustained recovery is the prospect of huge federal deficits even as the economy expands. In the last fiscal year, the federal deficit was a record $111 billion. The President's new budget report projects a deficit in the current fiscal year nearly double last year's figure and further growth into the foreseeable future in the absence of determined action to alter that outlook.

The members of this Committee, of course, are well aware of the enormity of these projected deficits, but there may be a danger that numbers in the $200 billion plus range have been cited so frequently as to make them seem almost comfortable and familiar. No matter how readily $200 billion slips off the tongue, the hard fact remains that deficits of that magnitude would preempt an unprecedented share of our net savings, keep "real" interest rates high, and divert funds from the investment and the housing we need and want.

To be sure, a substantial part of the current deficit -- projected at about 6½ percent of the GNP -- reflects the impact of the recession on the budget. Slack economic activity and higher unemployment have cut deeply into revenues and boosted outlays for unemployment benefits and other automatic stabilizers. At a time when investment is weak and private credit demands have slackened, these cyclically induced deficits have helped support spendable income and buoy the economy. They have not, in the midst of deep recession, been inconsistent with declines in interest rates -- but interest rates have, as you know, remained high relative to the current rate of inflation.

As the economy recovers, the cyclical portion of the deficit will recede. But as things now stand the deficit itself will not. Higher revenues from economic growth and reduced spending for unemployment compensation will be offset by -- and possibly more than offset by -- growth in other spending programs and the effects of earlier tax changes. In other words, through the mid- and late-1980s, a huge imbalance would remain even if the economy were operating at much lower levels of unemployment -- and assuming inflation remains under control.

All that is familiar to you -- and it is equally familiar to the financial markets, where the prospect of a major structural imbalance in the government's finances has an impact on current interest rates. It is not just the direct demand for funds to finance the Treasury that is of concern but the fear that ballooning federal borrowing needs will, in effect, bring extraordinary pressure on the Federal Reserve to monetize the deficits, with implications for inflation itself, for inflation expectations, and for inflation premiums in nominal interest rates. One implication is that, to the extent the budget deficit appears to be intractable, the burden placed on monetary policy to demonstrate the government's resolve to follow a non-inflationary course is intensified. The converse is equally true: meaningful action to demonstrate the government's economic discipline on the fiscal side would reinforce confidence that monetary policy over the years ahead can do its job in maintaining a course consistent with price stability without intolerable market pressures.

It is tempting for some to suggest that the budget problem and its consequences for the performance of the economy could be solved by monetary policy. But excessive money creation to meet the needs of the government would only reinforce and validate the fears of renewed inflation, and sooner or later, higher interest rates. In the end, excessive monetary growth would put us in an even more unsatisfactory situation, with still more deeply ingrained inflation expectations and greater skepticism about the ability of our nation to manage its economic affairs. Nothing real would be gained for long, and hard-won ground in the battle against inflation would be lost.

In concept, any inflationary impact from the budget can be contained by appropriate monetary policy. But the harsh implications of excessive deficits for other credit-dependent sectors of the economy would clearly remain.

I don't want to suggest there is a simple trade-off, as sometimes suggested, between future budget policy and current monetary policy. Reducing the threat of those large structural deficits stretching out to the end of the decade in and of itself should have favorable effects on current interest rates and in damping concerns about future increases. In that real sense, budgetary virtue will provide its own tangible reward.

But those benefits would ultimately be lost if monetary policy were to abandon its continuing and necessary concern with restoring reasonable price stability. That point remains central.

What can be said is that a better fiscal outlook, with all it implies, would certainly provide a better environment in the financial markets today, reduce concern about future inflation and an early rebound in interest rates, and moderate preoccupations that the Federal Reserve itself might somehow be forced to retreat from its basic anti-inflationary course. As things stand, with monetary policy assumed to be the only bulwark against renewed inflation and a high degree of sensitivity to the past failures in efforts to contain inflation, every twist and turn in the monetary aggregates or short-term policy actions interpreted as "easing" is closely scrutinized as a sign or symbol of intentions over a longer period. Clear progress in dealing with the budget could, in that sense, somewhat enhance our operating flexibility, so long as we succeed in reinforcing the basic point that the effort to sustain the progress against inflation is intact.

As you know better than I, the process to cut down those future deficits must start now, and with energy and force. Basic budget trends take time to change, but the knowledge that they will be changed will affect markets now. The amounts involved are large, but certainly not beyond our capacity.

It is obviously beyond my competence, or the province of the Federal Reserve, to deal with all the particular priorities that must be balanced. The Administration has set forth its program in that respect. The general order of magnitude seems to me appropriate, although some of the measures proposed would, in my judgment, be more effective if brought forward in time.

Others have proposed different specifics, and I am sure they will receive consideration.

From the standpoint of general economic policy, the more that can be done in restraining expenditures the better. You, of course, have to reconcile that with other priorities, and the basic point is that the sheer arithmetic of the problem does suggest that changes will be necessary over a broad range of programs -- both on the spending and revenue side. I believe recognition of that fact is becoming increasingly widespread both in and out of Washington.

Your Committee is in the critical position of converting that wide consensus on generalities into a specific program, and I have some idea how difficult that is. But I also have some idea how important it is to our future.

Conclusion

I need not dwell on the fact that we are negotiating a most difficult period in our nation's economic history. But I also believe we are in the process of laying the base for more vigorous, and lasting, non-inflationary growth. In looking to the rest of the decade and beyond, there are, in my view, strong forces at work that should lead to a kind of self-reinforcing process of growth, greater price stability, higher real income and profits and declining unemployment. But there are obstacles to that prospect. Monetary and fiscal policies alike need to be directed, and work in concert, toward removing those obstacles and achieving that bright promise.

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Chairman DOMENICI. Senator Gorton, I was going to yield to you, but Senator Chiles has indicated that he has an urgent engagement and he has to appear at another committee, and I wondered if you would mind if we yield to him, and then I would be pleased to let you proceed.

Senator GORTON. I understood that he would precede me, but I would be happy to yield.

Chairman DOMENICI. Senator Chiles?

PERMANENT $30 BILLION TAX CUT

Senator CHILES. Thank you, Mr. Chairman.

Chairman Volcker, I do want to ask you if the third round of the tax cut was not already written into law, and as we are sitting here with a $200 billion deficit, would you recommend a permanent, $30 billion tax cut to stimulate the economy this summer?

Mr. VOLCKER. I probably would not recommend that on its own; it depends upon what happens in the economy, and I am assuming we will see some recovery during that period of time.

That tax cut, of course, when enacted was justified in a longer term sense in major part and maybe in its entirety, on the desirability from an incentive standpoint, of getting down marginal rates of taxation. I believe that that is a desirable goal over a period of time.

Senator CHILES. I think it is a wonderful goal.

Mr. VOLCKER. Even if it were not on the books now, and you proposed a program that said, "Let's reduce those rates and offset those revenue effects by other actions on the spending or revenue side," then I would say yes, that is a good idea.

DEFICIT REDUCTION BY MONETARY POLICY IMPOSSIBLE

Senator CHILES. But you would not want to do that if we were going to offset them on the monetary side, would you?

Mr. VOLCKER. You cannot offset these things on the monetary side. The idea that there is some kind of trade-off—that you can get rid of the problems of a deficit by easing monetary policies—I just think is invalid. If that were true, you might as well not raise any revenues at all.

Senator CHILES. I would just say that we are finding out, and the administration is, too, that the idea that you can offset that amount of revenue simply by making another cut is just about as impossible today as your statement that you cannot do it with monetary policy.

Mr. VOLCKER. I did not suggest that you are going to offset it by another cut. I said you have to offset it by another increase, or by spending reductions; ideally, you would do it by spending reductions.

Senator CHILES. I meant spending cuts, not a tax cut.

Mr. VOLCKER. All right.

Senator CHILES. I am saying to you, just as you are saying it is impossible to reduce it by a monetary policy—and I agree—I can tell you as a practical political thing, we are finding out, and as the administration is finding out, if you look at the presentation of their budget, that you just cannot go in and say you are going to offset it by revenue spending cuts.

Mr. VOLCKER. I agree; I have said in my statement and have said consistently that I do not see how you can handle this total budgetary problem without increases in revenues and tax changes. But having said that, let me point out that it is the spending side of the budget that historically is high; relative to GNP, the spending side is reaching new records. From an economic standpoint, that is undesirable. There are other things you have to take into account, quite obviously, in making budgets. But looked at from the standpoint of economic policy, it is the spending side which has gone up, reached a new high or is projected to reach a new high this year, I believe, as a percentage of the GNP. If you did everything the administration outlined, it would come down a little, but it remains very high historically. If you look at the projections for the next 5 years, it would be the highest ever relative to the GNP. In that sense, it seems to me quite clear, from the standpoint of general economic policy, that the priority is to do all you can do on the spending side. I do not disagree with your judgment that having done that, you are going to have to end up with something to do on the revenue side, as a practical proposition. But I do not want to take the emphasis off the spending side at this point.

BRING SOME DEFICIT REDUCTION MEASURES FORWARD

Senator CHILES. I understand. But getting to your point of having to do something on the revenue side, I notice in your statement, you say it would be preferable if some deficit reduction measures were brought forward in time.

Mr. VOLCKER. Right.

Senator CHILES. Does that mean that we should be doing something on the revenue side now?

Mr. VOLCKER. When I look at the administration program, for instance—and looked it over a 5-year time horizon as they presented it—it seems to me the order of magnitude of what they propose over that period is broadly appropriate. We can always quibble over these figures, but it is broadly appropriate. When I look at the timing of that, yes, I would bring some of it forward a year.

Senator CHILES. You would bring it forward?

Mr. VOLCKER. Yes.

INTEREST RATES TOO HIGH

Senator CHILES. The interest rate, we note, is currently 11 percent on prime, and the AAA bond at 12 percent, even though we see that the inflation rate is 4 to 5 percent, and you are saying now by your statement that you expect that, if anything, the projections are on the high side for inflation, and with the oil situation that we see, that is going to go down even more. We continue to see this real interest rate so very high, again up to historical standards, and when we make all the statements about inflation expectation—and I know those are real, that there is a problem there—but not only in the long-term rates, but we are seeing this tremendous spread in the short-term rate. At what stage is the Fed going to do something to indicate to the banks that you think that spread is too high and that it ought to come down? At what stage is the Fed going to give some kind of direction to the banks that some of the profits they are making off of consumers are vulgar and that they ought to be doing something to reduce that spread? That would do more for the recovery rate than anything we have talked about.

Mr. VOLCKER. I think you have to distinguish between interest rates, first of all, whether we are talking about market interest rates, the corporate bond rate, the Treasury bill rate, the bank CD rate, we are talking about rates that are set in highly competitive, literally worldwide markets. The banks aren't doing anything to hold up those rates. If you believe the administration's inflation forecast for the next year, you are a little hard-pressed to say short-term rates are so extraordinarily high. I am talking about the market rates; I will get around to the bank rates in a minute. Market rates are not low, but they are within 3 percent or so of that inflation forecast. I happen to think that forecast is high. Certainly, if you just look at the current inflation rate against those market rates, as a generality, the market rates are high historically, and I think the uncertainty about the future for inflation is a factor there.

As to the bank rates—as the phrase goes, "administered by the banks"—and particularly the consumer loan rates, I think those consumer loan rates have come down rather sluggishly in the past 6 months, for several reasons. One reason is that, perhaps they were not as high in relation to market rates as they normally are when the market rates were very high. But take an auto loan rate; it is basically a 4-year rate. Other consumer loan rates are maybe 2 years or 3 years or 4 years. There is a certain amount of caution in those rates; how will they look a few years from now or a year or two from now relative to market rates then? Most recent experience has been with very high market rates, and I think you can understand a degree of caution. I think banks also have probably been concerned about their profit margins, concerned about some experience they have had—actual and potential—with loans, and they have not been extraordinarily eager and aggressive, for that reason, to bring down the rates.

COMPETITION FORCING RATES DOWN

Senator CHILES. So they take that all out on the consumer. We know they have problems with their foreign loans. We know they have got problems with some of the other loans they have made that are bad.

Mr. VOLCKER. Competition is forcing those rates down now, and my sense is that they are declining. They are declining more rapidly now than they were a few months ago. They still look relatively high.

Senator CHILES. But Mr. Chairman, the competition is forcing them down. Why can't there be some statement from the Fed, or why can't there be some statement from the President as to just what you are saying, that those rates are rather sluggish—I think you could describe it a little better than that—they just have not come down at all.

Mr. VOLCKER. They have come down. You say they have not come down at all. They are in the process of coming down, and they are coming down more. A new car buyer now can finance his car at 11.9 percent.

CAR LOANS BEING SUBSIDIZED

Senator CHILES. Well, that is because it is being subsidized by the companies.

Mr. VOLCKER. I do not know to what degree it is being subsidized. They are able to offer 11.9 percent because those finance companies can how borrow in the market——

Senator CHILES. They did 10.8 last year, when they were trying to move the old models.

Mr. VOLCKER. That is right. They have certainly been forcing it, and there is an element of promotion, but the rate is also permitted by the fact that those finance companies can now borrow—to the extent they are borrowing on commercial paper, which they do—in the 8½ percent area. So the market rates have set the stage where that kind of "promotional effort," if you will, is possible.

Senator RIEGLE. Would the Senator yield just briefly at that point?

Senator CHILES. I yield.

Senator RIEGLE. Only to make the point—I have talked with all the auto companies, and there is one company that is making money on the financing transactions, and the others are not.

Mr. VOLCKER. I think that may be right.

Senator RIEGLE. Well, that is an important distinction. I would not like the suggestion to stand that they are all making money with the subsidized rate when in fact, all but one are losing money on the subsidized rate.

Mr. VOLCKER. That depends upon just how you calculate it marginally, what other costs you allow, what allowance you make for bad loans, and all the rest. Certainly one of those companies is in a far stronger position than the others.

Senator CHILES. Well, Mr. Chairman, I notice that the President has now said that lower rates are up to the banks, jawboning the latest sign of displeasure with the industry. If the President is now ready to jawbone, why can't the Fed do a little jawboning?

Mr. VOLCKER. He outranks me.

Senator CHILES. Well, but he is your leader. He is our leader. If he is ready to lead, are you ready to follow?

INFLATION OUTLOOK SUGGESTS CONSUMER LOAN RATES ARE TOO HIGH

Mr. VOLCKER. I have expressed my opinion and analysis. I think these rates have been sluggish to come down. I think they are in the process of coming down now. I would obviously be delighted to see them move lower.

Senator CHILES. Do you think they should come down?

Mr. VOLCKER. I think they not only should but will, in the kind of economic environment that I foresee. But I think we have got to go to the fundamentals here. Our policies are designed to provide what reassurance we can that inflation is not going to go up again. That is the only environment in which there will be the confidence to get those rates down and keep them down. It is not going to do us any good to jawbone the banks, with our words if our actions suggest to the banks that inflation may go up and interest rates therefore may go up. To the extent we can contribute to confidence that this lower inflation trend is for real——

Senator CHILES. Well, sometimes after we think we have contributed some to confidence, we need to nudge people a little bit to remind them that we have done something, and we expect them to do something in turn. Now, that is what I want to know—is the Fed ready to do a little nudging?

Mr. VOLCKER. My whole statement is designed to reflect my own feeling about the inflation outlook and our intentions, and I have expressed the view that, against that outlook, I think some of those consumer loan rates remain quite high. I think they are in the process of coming down. That seems to be what you are suggesting I ought to say, and I am saying it.

Senator CHILES. Thank you.

Chairman DOMENICI. Senator Gorton?

INTEREST RATES HIGHER THAN RATIONAL HISTORIC GROUNDS

Senator GORTON. Mr. Chairman, I would like to deal for a while with exactly the same subject about which Senator Chiles asked you questions and perhaps approach it from a slightly different area.

Would you comment on the President's statements yesterday that many interest rates are higher than any rational, historic grounds would justify?

Mr. VOLCKER. I did not read the President's statement closely. I do not know whether he said that or not—at least, I did not read that precisely. I would say that——

Senator GORTON. Well, he felt at the very least that there was room for a further decline of 1 or 2 percent.

Mr. VOLCKER. I think interest rates generally are high relative to the current rate of inflation, looked at historically; they are not unprecedented, but the statistical record is very clear that the current level of rates is high relative to the current rate of inflation.

GROWING CONFIDENCE NEEDED TO BRING INTEREST RATES DOWN

Senator GORTON. And you, of course, have been very, very consistent on this subject during the course of the last 2 years. You have advised this committee on fiscal policy, and by and large, you have agreed that what this committee has done has been positive in nature. You have also undertaken monetary policy which was designed as best you could to balance concerns of inflation with interest rates. You, I know, have been disappointed as we have been that the movement in that direction, while it has been gratifying, has not been as great as you would have liked.

Are you essentially telling us that there is a certain degree of frustration in your own efforts in this respect, that we can only continue to do what the Federal Reserve Board has done in the past and what the Senate Budget Committee has done in the past, that there is no other way in which we can work for a rather sharp and immediate lessening of interest rates?

Mr. VOLCKER. I guess my job is a combination of continuing frustrations and occasional satisfactions. But basically, I am saying the answer to your question is yes, there is no way you are going to get those interest rates down and keep them down unless we have confidence, and growing confidence, that inflation can stay down and, in fact, that events show that is a valid expectation as time passes. A very important additional consideration here is the budgetary outlook. However frustrated we get, I am afraid that remains the fact; just because you may be more frustrated a year later does not change the facts. The deficit is still there. Inflationary concerns are substantially diminished. Nominal interest rates are down. But there is still a lot of skepticism, and that is very frustrating. But when you stand back, I think you have to be able to understand that after 10 or 15 years of accelerating inflation, neither housewives nor financial markets are totally convinced by 1 year of very real progress—although I think the signs betoken more progress.

Senator GORTON. So, to coin a phrase, we have to stay the course?

Mr. VOLCKER. Exactly; in those respects, certainly.

NATURE OF DEFICIT DIVIDED 69/31 PERCENT

Senator GORTON. On a different subject, while I am sure the chairman himself will question you about this, you heard his opening statement here today, dividing the nature of the deficit on a 69/31 percent basis between a weaker economy caused by higher interest rates and the like as against those elements which are more directly under the control of the Congress. Our chairman states to a very significant degree that these are the results of monetary policy and not fiscal policy.

I wonder if you would comment directly on the chairman's statements?

Mr. VOLCKER. Somebody just handed me that table that I think the chairman was referring to. Having given it 15 seconds of analysis, I want to reject the charge.

If I understand this table, from a very hasty reading, what it shows is that a large part of the problem is due to an economic outlook that has changed from the economic outlook that was presented in 1981. That was a very optimistic economic outlook, you will recall. I do not think it was one that was shared by the Federal Reserve, and I disclaim all responsibility for that change in economic outlook being due to monetary policy. There are different assumptions in that table, and I presume that is reflected in these numbers.

I think the way to look at this—which is clear, I am sure, in other tables and analysis presented by the Congressional Budget Office—is to try to make some judgment about how much of the deficit now and prospectively is due to the economy operating below par. Of course, we are way below par now, and I have no disagreement at all in terms of the general order of magnitude in the Congressional Budget Office analysis of that matter. What they show is that the so-called structural deficit—that is, abstracting from cyclical effects, abstracting from the fact that the economy is currently operating below par—rises from about $70 billion in 1983 to over $200 billion in 1988. That is precisely the problem. It has nothing to do with Federal Reserve policy. That is their estimate of what the deficit would be with the economy operating up to its potential, in general terms.

So that estimate of the structural deficit may be different—I am sure it is different—from what they made in 1981, but it is their best estimate at this time, and it is very close to the kind of estimate that I would make.

Senator GORTON. Thank you, Mr. Chairman. I am sure the chairman of the committee is going to continue to question you on those subject matters. I am waiting for that, but my time is up.

Chairman DOMENICI. Senator Riegle?

NO REASON BANKS COULD NOT BRING INTEREST RATES DOWN

Senator RIEGLE. Mr. Chairman, what the President is quoted as having said is as follows, and I quote directly:

> With inflation at the level it is, interest rates can come down and should. This is up to the banks. There is no reason why the banks could not bring those interest rates down another notch or two.

Well, that is a very direct commentary. Is the President right?

Mr. VOLCKER. I think the first part of that statement is the same thing that I said. I said it in the Banking Committee, and I will say it here again this morning: Those interest rates are high relative to the current rate of inflation. If we can maintain that current rate of inflation—more important, if we can see further reductions in it—these interest rates ought to come down.

So far as the bank rates are concerned, I do not think the banks are responsible for the rates in the open market, the Treasury bill rate, the commercial paper rate, the corporate bond rate, and all those kinds of rates.

Senator RIEGLE. I understand that. You made that point. But that is not what the President is saying here. He is saying there is no reason why the banks could not bring those interest rates down another notch or two. That is the punch line. Is he right in that point?

Mr. VOLCKER. If he is talking about consumer lending rates——

Senator RIEGLE. I would assume that he probably means that, and he probably means the prime rate. That is what most people, I think, take to mean bank rates.

Mr. VOLCKER. I think the spread between the prime rate and market rates is relatively high. It has tended to be relatively high in recent years, and that is part of the caution in bringing rates down. I would point out that a great volume of short-term loans by banks these days are made below the prime rate.

Senator RIEGLE. But you know, I do not think you are answering me directly, and I would like you to. That is, he is saying there is no reason why the banks could not bring those interest rates down another notch or two, and I am asking you is he correct in that assessment; is that right?

Mr. VOLCKER. If he is saying that consumer lending rates—if that is what he is focusing on—could be lower consistent with the level of market rates and consistent with the way I see the outlook, then the answer is, yes, I think they could be lower; I think they are in the process of moving lower.

Senator RIEGLE. Well, he says they should come down. I mean, he uses the word, "should."

Mr. VOLCKER. I think they should come down, too, in the sense I think they are out of equilibrium. If the rest of my analysis is correct, I think those rates are too high, and they will come down.

CREATE CONFIDENCE THAT INFLATION IMPROVEMENT IS FOR REAL

Senator RIEGLE. Yes, but what can you do to help that happen?

Mr. VOLCKER. I think the most important thing I can do to help make that happen—we, in the Federal Reserve can do—is to create as much confidence as possible that, indeed, this inflation improvement is for real.

Senator RIEGLE. Let me be more specific. Are there any additional direct policy steps you can take at this point, whether it is by being more outspoken, as the President has now elected to be on the issue, or are there internal mechanisms that you could use—could you pick up the phone and relay this message to some of the lead banks, if you agree with the President's thinking—have you thought about that—or do you not agree to that extent with what he is saying?

Mr. VOLCKER. I agree with what he is saying in the words I have used; that is, I think these consumer lending rates are high relative to market rates. They are certainly high relative to the inflation rate. I think they are coming down. They have come down quite slowly and cautiously. I think there is room, and significant room, for them to come down further, given the outlook that I see.

PRIME SHOULD BE 10 PERCENT

Senator RIEGLE. Let us take the prime. Is there any reason—and again to use the language of the President here—is there any reason why the prime today should not be 10 rather than 11?

Mr. VOLCKER. Ten percent would be, in fact, a more normal historical relationship with market rates. An awful lot of lending, as I said is, done below the——

Senator RIEGLE. Would you prefer to see it at 10?

Mr. VOLCKER. Would I prefer it? Yes. If I can have lower interest rates, everything else being equal, I prefer it, yes.

Senator RIEGLE. No, but I am not asking it that way. I guess what I am saying is in your professional judgment now, do you think that in fact it could be 10 and more properly should be 10?

Mr. VOLCKER. I think it could be 10 in some sense; I hesitate to say "more properly". I think that is a decision that the banks in the end have to make themselves. I think it could be 10, just in terms of past relationships, and then perhaps that is reinforced——

Chairman DOMENICI. Senator, would you yield?

Senator RIEGLE. Yes, I would. I would like to keep a little bit of time, but I will yield.

Mr. VOLCKER. If I may just add one other thought, that may be reinforced by the fact that so many short-term loans are made at rates substantially below the prime rate today.

Senator RIEGLE. Well, that is true, but that tends to be for a particular class of borrowers, as is wellknown. The small firms have a much tougher time, and usually pay premiums for their borrowing, as you well know.

Mr. VOLCKER. I think that is true.

Senator RIEGLE. I want to reserve the rest of my time, but I am going to yield to the chairman.

BUILD CONFIDENCE AS TO CONSUMER LOANS

Chairman DOMENICI. Yes, I am going to give you your time. I just wanted to follow up with something you said in terms of confidence.

Mr. Volcker, how much more do we have to do to build confidence regarding consumer loans? You yourself are predicting a lower inflation rate in 1984 than the President is projecting.

Mr. VOLCKER. That is correct.

Chairman DOMENICI. And it seems to me there is no response, in terms of what the consumer loan rate is, to the inflation rate that you are referring to.

Mr. VOLCKER. I do not think it is right to say no response. Those rates appear to be coming down. You see the absolute leading edge of that, indeed, in the promotions to give sales incentives for autos. But again, it is in a particular environment of interest rates so far as the sales finance companies are concerned. They make most of the auto loans these days. You have seen the mortgage rates come down substantially. They are still high. If this were an environment of complete confidence that the inflation picture were going to stay as low as it is, much less decline further, those rates would be extraordinarily high. But they have come down. Unfortunately, this just does take time.

CONSUMER LOANS NOT BASED UPON INFLATION EXPECTATIONS

Chairman DOMENICI. Well, I am going to give the Senator more time.

I just want to say I am beginning, really, to believe, Mr. Chairman, that the average bank as it pertains to consumer loans, does not base their action at all upon inflation expectations. I cannot tell you on what it is based at this point in time, but I do not believe it is based on inflation expectations.

Mr. VOLCKER. I do not think that is the whole story. I think that is part of the story. It is a basic part of the climate. But, obviously, there are more particular factors. It is not just inflation. Another basic part of the climate is what will happen to interest rates, let us say, due to the deficit. There are more particulars. I think that the banks have been exceptionally cautious, reluctant to reduce these rates in a hurry, reluctant to be on the leading edge because of concerns over their internal problems. I think that is a factor, has been a factor.

Chairman DOMENICI. I have one more, and I am certainly going to give you plenty of time.

Senator RIEGLE. Please do.

INVESTMENT OF LOCAL MONEY TO OTHER THAN LOCAL CONSUMERS

Chairman DOMENICI. I am aware of a former Senator who sat on this committee that is on a bank board in a local community. He sat at a board meeting and observed the decision to invest local money at an interest rate 4 percent less than they were willing to lend it to local consumers, and both were of equal duration in terms of the loan. The only possible reason could have been, as I see it, that they did not want to take any risks with the local people because the investment they were making was more secure—but the same duration, 4 percent different interest rate, and he was actually appalled, and wondered who they were supposed to be serving, the local community of consumers who caused them to have money—that is where it all came from, from that area—or some other interest that we are unaware of.

Mr. VOLCKER. I obviously do not know about that particular case, but let me just make a couple of additional observations.

Over the past couple of months—beginning particularly in December; it is now subsiding—the banks and the thrifts were all engaged in hot and heavy competition over this new money market deposit account. They were paying extremely high interest rates, wisely or otherwise, for those funds, and I am sure that in itself was a factor in slowing down the decline in consumer rates. The fact that they were paying 11 percent, in some cases more, to raise money from consumers led them at that particular time, at least, to say, "We have got to invest that money profitably."

In terms of comparing consumer rates with other rates—and I do not know what particular comparison was made in the case that you cite—consumer loans do have a cost element built into them that many other loans do not, a servicing cost plus an allowance for normal credit losses. That persistently, structurally, results in consumer rates being higher than the rate that a large businessman would get, certainly higher than the rate the U.S. Treasury gets, and it is always a significant margin in that rate-setting process.

Chairman DOMENICI. I just wanted to make the point from my standpoint—the reason I ask these kinds of questions and the reason I think my fellow colleagues are asking them is not necessarily to be critical of your monetary policy, but it appears that there are forces at work that in spite of, cause that to occur.

Senator GRASSLEY. Mr. Chairman, could I enter in on that same point? I would like to contribute something on that same point.

Chairman DOMENICI. All right, and then we will give Senator Riegle back the time.

Senator GRASSLEY. Is that all right, Senator Riegle?

Senator RIEGLE. Sure.

BANK EXAMINERS SPREADING TERROR AMONG BANKERS

Senator GRASSLEY. The environment that you stated of one bank director who you know, that environment is rampant throughout rural America. That is not an isolated incident. And what is behind it all—and you cannot say for sure, and maybe I ought to preface that I cannot say for sure—but I get the feeling when I talk to the excuses given to farmers in my State, that there is always some reference back to bank examiners. And I think that throughout the banking industry—and it has got to be fomented from Government regulators and Government agencies, like the FDIC and the Comptroller General and the Fed, that they are creating a hysteria out there that is just spreading holy terror among bankers so that they are afraid to do what you are suggesting that legitimate bankers ought to do. And I see a banker as responsible to the constituents they serve as I am responsible to the constituents I serve, and they are not able to serve those constituents because of terror spread by Government agents.

I think that is what is behind it, and I think there is an attitude that has got to be changed, and there is no one better in a position to change it than the Chairman of the Fed and the Comptroller General and the head of the FDIC, and how that filters down to the State agencies that are superintending banking. That is what I feel.

Mr. **Volcker**. If I may respond to that observation—and I am glad you raised the question, because I have heard it before in somewhat less forceful terms than you have expressed it——

Senator **Grassley**. I tend to appear to always be mad. I want to say I am not mad, but I am trying to lay something out on the table here for discussion.

Mr. **Volcker**. It is a serious question, and I am glad you raised it. As I say, I have heard some lower key allegations of that sort before——

Senator **Grassley**. Well, I hear it on the phone on weekends when I am home and the farmers call me up.

Mr. **Volcker**. Well, I have——

Senator **Grassley**. You do not tell a farmer on February 22 that he has got to sell out on March 1. That has got to be said before September 1, before he rents 780 acres of land.

Mr. **Volcker**. I have specifically asked our bank supervision and bank examination people whether they have consciously or subconsciously tightened their loan review standards in the examination process and contributed to the kind of psychology you report. They have looked into it—and I speak for the Federal Reserve now, directly; it is the only Agency I can respond for—and I get an unambiguous response of no. I have no reason to believe it is true of the other agencies either, but I was concerned enough that I specifically inquired and asked for a review of this matter, and the response that I have gotten is no.

Chairman **Domenici**. Senator Riegle?

STRUCTURAL UNEMPLOYMENT

Senator **Riegle**. Thank you, Mr. Chairman.

I want to just try to pose one other issue—and there is a lot more we could say on this one—but it relates to the jobs problem and the fact that we have a massive unemployment problem in the country, and the projections are that it is going to continue. The Reagan budget calls for unemployment at 10.4 percent at the end of this year, 9.5 at the end of next year, and it is not clear that we are going to be able to hit those numbers. Unemployment may hang higher than that.

I am sure you saw yesterday—and I want to build this into my question to you—that the Atari Co. has decided that they are going to move, I believe it was 1,700 jobs offshore—production jobs in a high tech field, now—and they are going off either to Singapore or to Hong Kong with that production, and the suggestion is that this is not just an isolated case, but that this is part of a growing pattern of movement that we have earlier seen in the industrial base over a much longer period of time. And I am very much concerned about the effect of structural unemployment that goes to sectors and that goes to this changing world trade pattern, and there are many things that bear on it, in terms of how it creates an impact that comes right back through to the deficit and in turn to interest rates.

Obviously, if we are going to have 8, 9, 10, or 11 percent of our people in this country unemployed on pretty much an ongoing basis, the financial implications of that on both deficits, lost national production, transfer payments to support unemployed people, as well as, finally, the impact on interest rates, are a whole new condition for us to consider. In the post-war period, certainly, we have not had anything like that where we have plateaued out at that level of uemployment where we have had that additional financial consequence to have to try to weigh on macroeconomics terms.

My question is this. I am wondering if the Fed has really tried to analyze the drag of this structural unemployment and the magnitude of it on now an ongoing basis, as it works its way through both the Federal deficits and to its impact on interest rates and the degree to which it actually makes it more difficult for us to get interest rates down and keep them down, because any factor that keeps deficits too high, as you have earlier said today, has that influence—and my hope would be—and I do not know what your answer will be as to whether the Fed has really tried to dig into this new problem, which I think is now with us as a fact of life in this timeframe—and if not, my hope would be that you would be willing to do so on the basis of a specific request by this Senator, and I would hope to be joined by other Senators who feel that this is now an issue that we really ought to get front and center. I would welcome your comments on it.

Mr. VOLCKER. To the best of my knowledge, we do not have any analysis that takes us to the particular points that you raise. Indeed, I would not accept the premise of your comments, at least in degree. We may have some structural problem, but I do not accept the notion that those structural problems lead to a plateau of unemployment for the indefinite future on the 10-percent level. I agree with the projections in the short run; history suggests that the unemployment rate is slow to turn around as we come out of recovery, and the general projections of recovery are not exceptionally fast, obviously, in terms of past cyclical experience. But I do not accept that, looked at over a span of 2, 3, or 4 years, we are stuck with that kind of unemployment.

DEFICIT RELATED TO UNEMPLOYMENT

Senator RIEGLE. Suppose we were. I mean, maybe you are right, and no one knows for sure, but suppose we passed into a new world trade circumstance where that is going to be a feature that is going to be there now over a period of several years, and if it were to be the case, would you think this would be something we ought to try to dig into more deeply in order to try to size up its deficit and interest rate impact?

Mr. **VOLCKER**. If that were going to be the case, there are a lot of aspects that we would want to delve into more fully. I think that has an implication for the deficit. But I would classify that and all these things, a little oversimplified in the cyclical category. That deficit arising from high unemployment has quite a different significance in my mind from the deficit that is there without the high unemployment, because it suggests that investment in the economy would indeed be sluggish, that the demand for housing would be less because there are so many unemployed——

Senator **RIEGLE**. That is exactly right.

Mr. **VOLCKER**. In those circumstances, the deficit—at least, that portion of the deficit related to the unemployment—does not have the same significance.

I do not believe that the structural level of unemployment is anything like that. I would not look at that deficit related to unemployment in the same light that I look at the problems created by the structural deficit. But we could provide you with a more considered and full analysis of that question.

Senator **RIEGLE**. I would appreciate that, because I think there is more and more evidence and scholarly opinion to the effect that maybe things have changed, and that we have a problem here that is new and different, and that has enormous implications of the very sort that you just described.

I would appreciate it if the Fed would take a detailed look at this and see what you find on the basis of that kind of analysis.

Mr. **VOLCKER**. I cannot help but interject that I think some of what is thought of as a structural problem with heavy industry is amenable to constructive change. How much of it is due to past failures to invest, to modernize, to past management decisions? How much of it is due to the fact our wages in those industries under the most critical pressures are way out of line with the rest of American industry as well as with foreign industry?

Senator **RIEGLE**. Well, that is why I mentioned the Atari thing, because that ought to set off a red light on your control panel—it does on mine—because that is a different situation than autos and steel, and I think it is a sign of things to come, and I would like to get you folks zeroed in on it quickly here, because I think this is of enormous national consequences and economic consequences.

I thank the chairman.

[The following was subsequently supplied for the record:]

The interrelationship of deficits, interest rates and persistent high structural unemployment is, at least, two sided. On the one hand, persistent high strucutural unemployment would probably be associated with a segmented economy in which resources could not move readily from one sector to another—e.g., from the automobile industry to the computer industry. In such circumstances, inflation could only be avoided if the aggregate level of spending and employment were sufficiently restrained to avoid bottlenecks in sectors where demand was strong. Viewed from this perspective, it would be appropriate to use a higher level of the unemployment rate as a benchmark for separating cyclical and structural components of budget deficits than would be the case if resources were more mobile. Using a higher unemployment rate as a benchmark implies that a larger proportion of any given budget deficit is structural rather than cyclical. Thus, a high level of structural unemployment does not provide an argument for a larger overall deficit but it may place a higher priority of using budget outlays or tax incentives where they can help to reduce the barriers to resources mobility.

Viewed from a different perspective, high unemployment in exporting or import-competing sectors could appear to be "structural" when, in fact, it is not—or at least, not entirely so. This situation arises when a combination of monetary restraint and large deficits forces up interest rates and the exchange rate of the dollar, thereby making imports cheaper and exports more expensive. Thus, excessive deficits have adverse effects not only on obviously interest-sensitive sectors, such as housing, but also on sectors most sensitive to international trade developments.

Chairman DOMENICI. Senator Symms?

SHORT-TERM LENDING MARKET

Senator SYMMS. Thank you, Mr. Chairman.

Chairman Volcker, just to make an observation, and then I do have a question I want to ask you along the line of what Senators Domenici and Grassley and others have brought up about the problem of the bank's lending.

In my part of the country, it seems like the banks that have gone in and lent long in the past few years are the ones that had the hardest time getting through the squeeze, and I think that answers part of the question that has been brought up here.

If you went out and started a new bank 2 or 3 years ago and went right into the short-term lending market while these people came through there real strong financially, and some of the older banks that were in there, lending long and trying to be good service to the constituencies ended up in a real crunch, as far as the savings and loans and the other banks that had invested.

Mr. VOLCKER. That is absolutely true. That experience is rather seared on the minds of bankers and thrift executives going back 5 or 6 years or longer.

MEXICO BORROWING ON SHORT-TERM MARKET

Senator SYMMS. However, let us just say that we did do things right here—and I have not yet seen the evidence of that, that Congress is truly going to step in and control the astronomical growth in all of the entitlement programs that is taking place, the pension programs, and so forth, but let us say, for example, that we do do it. In countries like Mexico, Brazil, Poland, and other countries, what is the Fed's plan and what is going to happen when we continue to see countries like Mexico borrowing on a short-term market—there is no long-term market to speak of, and they continually have to roll over this debt. Now, with oil prices going down, what is going to happen with Mexico? What is our plan, or is there a plan, to be able to lessen this pressure that is on, or at what point do you think Mexico will walk in and say, "We give up. We can't even begin to pay the interest." I think every dollar the price of oil goes down, they lose $500 million annually or something, and they owe, what, $80 billion.

Mr. VOLCKER. Let me say I do not think that is so much related to whether the loans are short or long term. Mexico, as part of the current financing program, is basically moving its short-term debt structure out a number of years. That is not impossible to do in these circumstances, because they are on a floating rate basis. They are not taking the risks that the institutions you referred to are; at least, the lender is not taking the risk, because while it may be a long-term credit it is on a floating rate basis, and that takes the interest rate risk out of it from the standpoint of the lender, not the borrower. But if the oil price declines appreciably, obviously, Mexico will have additional problems in meeting its short-term balance-of-payments aims. If all went smoothly, you would get some potential significant offset to that from lower interest rates themselves. Their debt is on a floating rate basis. If the anti-inflationary implications of that oil price decline are favorable, it should be a force bringing down interest rates, so they get some offset.

To the extent that growth in the rest of the world economy is improved, they get an offset through the volume of exports, potentially including oil exports. They may have room to expand their oil exports.

I cannot give you a definite answer to your question, although clearly the possibility exists that over this transitional period that we are already concerned about, Mexico would have to supplement its external borrowing.

FARMERS BEING FORECLOSED WHILE FOREIGN GOVERNMENTS GET EXTENDED CREDIT

Senator SYMMS. Well, the problem that bothers me is—and I think it is what these other Senators are alluding to here—it is very hard for any Member of Congress to have farmers who are being foreclosed by the local bank or the FHA or what-have-you, Government lending agency, Federal Land Bank, or what-have-you, in their States, and then come to find out the Federal Reserve is buying debt or extending credit in any fashion to foreign governments. Is that taking place?

Mr. VOLCKER. Both we and the Treasury have in some cases provided some very short-term credits to some foreign governments, while other, more lasting credits were being negotiated, basically, by the IMF. Yes, we have provided some short-term liquidity, some short-term lending, over a matter of months.

Senator SYMMS. If that is what is anticipated, then, in the case of a crisis like Mexico, that the Federal Reserve would buy up some of their debt?

Mr. VOLCKER. No; the Federal Reserve has provided some transitional, bridging financing while other more permanent credits or medium-term credits are put in place. We haven't got any role in providing the medium-term money. More longer term money would need to be provided in that case.

Senator SYMMS. In other words, Congress would have to vote an outlay, then?

Mr. VOLCKER. No; I am not saying that. That is obviously one kind of approach that could be taken. But Congress does have a vote, to use those words, in my judgment, in this kind of situation. It is another reason why you need ample resources, enough resources, in the International Monetary Fund, because that is obviously one line of defense. The International Monetary Fund has existing programs for lending in the case of an abrupt decline in raw materials export prices of a developing country. That has not been applied to the price of oil heretofore, but those possibilities would have to be looked at.

Senator SYMMS. Thank you.

Chairman DOMENICI. Senator Biden?

HOUSING

Senator BIDEN. Thank you, Mr. Chairman.

I would like to talk about housing in the few minutes that we have. Since the late thirties, it has been a notion of this Government that both private and Government-sponsored and inspired housing partnership is essential. But I am wondering whether or not that view is still held. I know that is not your direct responsibility, but as I see it, we are in tbe following position. The Federal Government is going to subsidize almost no new or major rehabilitation housing, and only 10,000 units of section 202 for the elderly, and the Federal Government is basically no longer a major supplier of new housing.

Second, the mortgage revenue bond exemption will terminate at the end of 1983, and this has been a major source of housing during the past few years, at least in my State—I do not know about the rest of the States.

Real interest rates are running at very high percentages, as you have heard all morning and as you know very well. In the budget presentations we have had so far, there is no budget document or presentation made to this committee that I am aware of that indicates that rates will be significantly lower over the next 5 years. Yet we are now counting on individuals to buy houses at mortgage rates of somewhere between 12 and 14 percent in order to restore the housing industry and provide some trickle-down housing for the poor.

HOUSING STARTS

Housing starts are up to an annual rate of 1.7 million units. Now, my questions are several. Do you believe that such a rate, such a start rate of starts at 1.7 million units, can be sustained for the next 3, 4, 5 years, under interest rates and economic conditions that you have indicated you foresee?

Mr. VOLCKER. Let me say that I think that rate of housing starts of 1.7 million in January was startlingly high to me. I do not think it necessarily betokens that that rate is going to stay at that level over the next few months. You ask about the next few years. I certainly think that is a sustainable rate for housing starts over a period of years, but my guess would be, my assumption would be, that you are going to have to have lower interest rates to support that level of housing starts over a series of years.

Senator BIDEN. Lower than what they are now?

Mr. VOLCKER. Lower than what they are now. I say that against a background of my expectation that inflation will be lower and, under those circumstances, I also believe that interest rates will, in fact, be lower. I do not think that is an impossible challenge or outlook and, indeed, quite the contrary. With that kind of inflation outlook, I could not understand long-term interest rates remaining as high as they are now.

Senator BIDEN. Do you believe that we need starts at that level for the next 4 or 5 years to meet housing needs in this country, or do you think we are overhoused already?

Mr. VOLCKER. As you correctly pointed out, you are a little bit outside my area of expertise, and I will not propound too many judgments, but a level of starts in that neighborhood, against what I know of demographic trends, against what I know of past history, does not seem unusually large to me at all. I would assume that our needs would be in that neighborhood, maybe higher.

IMPACT OF OIL PRICES ON INTEREST RATES

Senator BIDEN. One more question. I have been in and out of the hearing this morning, although I was here at the outset, because of the Adelman nomination in the Foreign Relations Committee downstairs, on which I serve, and if any questions along this line have been asked, please tell me, and I will check it out with staff.

Have you discussed oil prices and the effect they are going to have?

Mr. VOLCKER. No.

Senator BIDEN. Would you be willing to give us your estimate of what impact, if any, on interest rates a sharp decline, as some are now both either hoping for or fearing, and further decline in the price of oil would have—what impact? Is there any direct relationship, and how would you characterize the relationship?

Mr. VOLCKER. I would think, other things being equal, that a decline in the oil price is favorable in terms of interest rates declining.

Senator BIDEN. Thank you.

Mr. VOLCKER. For several reasons.

Senator BIDEN. Well, I would like to hear the reasons, if you are willing.

Mr. VOLCKER. First, there is an expectation and a realization and a considerable symbolic content in an oil price change that touches every consumer; to the extent that decline in oil price reinforces the view that the inflation outlook is improving, you get that psychological effect, which could be quite important. You also get the effect that, if the inflation rate is lower—and the oil price decline moves us in that direction—everything else equal, you have more money relative to real activity, and that is good for real activity and good for interest rates.

Senator BIDEN. Thank you very much.

Chairman DOMENICI. Thank you, Senator Biden.

Senator Hatch?

Senator HATCH. Thank you, Mr. Chairman, I have a statement that I would like inserted in the record.

Chairman DOMENICI. Without objection, it will be inserted at this time.

Prepared Statement of Senator Hatch

Mr. Chairman, I am pleased to have you with us this morning to inform us of the Federal Reserve's view of the current economic and budgetary outlook, and particularly of its goals for monetary policy. A sound monetary policy is crucial to putting our economic house in order and to the sustained noninflationary growth which will benefit all our citizens.

Since monetary policy is a critical part of our econmic health, I am greatly dismayed by the fact that the M_1 measure of the money supply grew at an annual rate of 8.7 percent in 1982—and at an even fasten annual rate since July of last year. This is a higher M_1 growth rate than the rates of 8.1 percent and 8.3 percent in 1977 and 1978, respectfully. And we remember only too well the inflation they produced in 1979 and 1980.

I am even more concerned because I hear a chorus of voices demanding an even faster growth in the money supply as a means to economic recovery through immediately lower interest rates. This policy is touted as a way to force a recovery of consumer spending by pushing short-term interest rates down to where consumers and businesses will be more willing to buy and borrow. But this is precisely the monetary policy mismanagement that, over the last 15 years, has produced the rising average rate of inflation.

We need long-term solutions, not quick and cosmetic "fixes." Proper monetary policy—a stable, gradual growth in the money supply—is not a panaeca. But it is a necessary, and much more certain, road to lowering interest rates and to economic recovery in the months and the years ahead.

I hope we can enlist the Federal Reserve in this effort.

LONG-TERM RELATIONSHIPS BETWEEN MONEY, THE ECONOMY, AND PRICES

Senator **Hatch**. Mr. Volcker, I have a certain sense of deja-vu in considering your testimony of the last several days. You imply that current conditions excuse the recent rapid spurt in the growth of the money supply and that they might do so again in the future. This sounds to me a little bit like the testimony of Dr. Arthur Burns, which I think, was given back, I think, before the Senate Banking Committee back on November 9, 1977. In that testimony, he stated that at times zigzags, rather than slow stability, in the growth of the money supply might be desirable. In response to a question about why and how zigzag growth might be desirable, Dr. Burns said that the Federal Reserve "* * * must be aware of changes in the demand for money by the general public, businesses, and individuals, and at times that demand could zigzag." Yet in the same testimony, Dr. Burns admitted that the relationship between business activity and money growth over short periods of time was very loose and, although the relationship between money and prices was such that little influence might be seen today or in 6 months, or 1 year, that sooner or later an abnormal amount of money would or could affect prices.

Now, you and all of us are concerned about precisely that longer term price stability. But isn't it true that, as even Dr. Burns admitted, sooner or later this abnormal amount of money will affect prices, and sooner or later that abnormal amount of money will be detrimental to price stability?

Mr. **Volcker**. Yes.

Senator **Hatch**. The answer is "yes." Long question, short answer.

Mr. **Volcker**. If you want me to amplify the answer, I Will. I usually get criticized for short questions and long answers.

Senator **Hatch**. I think your answer is a good answer.

Mr. VOLCKER. Let me say that the whole key is judging what is abnormal, and I do not mean to be mystifying about that. There are certain established, long-term relationships between money and the economy and prices that we have to count on to the extent we can count on anything. That is the foundation for building these targets.

There are grounds for suspicion currently that some of those relationships may be changing, and that involves a difficult problem of judgment. We are caught between two difficulties. If it is changing, and we do not judge it correctly, we have a policy different from what we really want. On the other hand, it is very easy to overinterpret what is going on currently, to assume there is a change that in the light of later developments does not prove to be a change after all. Then you have made a mistake in the other direction. There should be a presumption that the relationships do not change, or change only slowly, and that would be our normal presumption. I think that should be the normal presumption.

MONEY SUPPLY GROWTH MAY LEAD TO LONG-TERM PRICE INCREASES

Senator HATCH. Well, some might suggest that with an annual growth in M_1 of 8.7 percent in 1982—and, of course, there was an even faster annual growth rate since July of last year—and if you consider that 8.7 percent is a higher growth rate of M_1 than during the Carter administration—I think it was 8.1 in 1977, and 8.3 in 1978—that that may be a growth in the money supply that will lead to long-term price increases.

Mr. VOLCKER. If there were no changes in the underlying relationships, I agree with that. We are, as all my testimony has indicated, very suspicious—more than suspicious—that there are some changes in those relationships, both cyclically and potentially, on a trend basis.

One aspect of that—not the only one, but one important aspect of that—is tied up in the fact that we have had some permanent institutional change. We now pay interest to individuals, on demand deposits. When you look at the experience of 1982, for instance, and decompose the money supply, you will find that the great bulk of the growth in M_1 came in NOW accounts, the part of M_1 interest is paid. I do not remember the exact figure for growth in NOW accounts, but I think it was on the order of 30 percent. For currency and demand deposits—which is the way we used to define M_1—the growth was, as I recall it, on the order of 3 to 4 percent. That looked much more normal last year, in terms of what was going on in the economy, than the new M_1 number which includes these NOW accounts. That leaves you with a question: To what extent does the payment of interest on transactions accounts, particularly during a period of declining inflation and declining market rates, introduce into M_1 an element that includes something like savings accounts as well as transactions accounts? To some degree, that certainly is happening. I think that direction is unambiguous. But you are left with the question of how much, and that is a very difficult question of judgment.

Senator HATCH. Thank you.

I think my time is up, Mr. Chairman.

Chairman **DOMENICI**. Thank you, Senator.

Senator Sasser?

HIGH INTEREST RATES WITH LOW INFLATION DISTURBING

Senator **SASSER**. Thank you, Mr. Chairman.

Chairman Volcker, we now have, as you said in your testimony, the lowest inflation rate in 10 years. As a matter of fact, it has been even longer than that since we have had a real lower inflation rate. In 1971 and 1972, as I recall, President Nixon had imposed wage and price controls, so that was artificially holding the inflation rate down at that time, and you are optimistic that the rate of inflation will go even lower, and I share that optimism. We see that oil prices are coming down. We have the highest unemployment rate in about 40 years, and that is not predicted to go down measurably or much in the next year or two. You have told us here in this committee, many times, that the reason for our high rates, and one of the problems and a strong contributing factor to high interest rates, is the rate of inflation.

Well, what is wrong here? What has gone wrong. We have this low rate of inflation. It is predicted to go even lower. We have these extremely high real interest rates. I was looking at some figures here. When you take the prime rate minus the GNP deflator, which is the most accurate, I think, measure of inflation, in 1978, the real interest rates were 1.7 percent; in 1979, 4 percent; 1980, 6 percent; 1981, 9.5—last three quarters of 1982, it was at 11 percent real interest rates as the inflation kept coming down.

Now, what has gone wrong here? Why aren't these rates coming down, as you had indicated they would, as inflation came down?

Mr. **VOLCKER**. The nominal rate certainly came down. Let me give you a shorthand answer that I think encompasses most of the truth. First, 1 year of good inflation results do not make up for 15 years of the opposite kind of experience, It begin's that process, but it does not finish it. The second part of my answer is implicit in the budgetary numbers that this committee is struggling with.

BANKS SHOULD SHARE SOME RESPONSIBILITY FOR HIGH INTEREST RATES

Senator **SASSER**. Well, as one Senator, I think I share the view that some of my colleagues here have suggested today, and the President indicated yesterday, that the banks themselves share some of the responsibility for the continuing high interest rates. I would suggest that I am not going to look with very great interest on going out and borrowing $8 or $9 billion to beef up the International Monetary Fund, to help the large banks in this country who, through bad banking judgment, it appears to me, have over-loaned, and cannot collect these loans unless they can exhibit some more responsibility in trying to bring interest rates down. I have a hunch that if that talk starts circulating around here, that many more of my colleagues will agree with that. The nine largest banks in this country have lent out about 200 percent of their equity capital, over 200 percent of their equity capital, internationally, to the less-developed countries. Now they are in difficulty and want the IMF to assist them. You, in your statement today, indicated that the International Monetary Fund has a special and indispensable role to play in this problem. Well, maybe it does, but I would suggest to some of our friends in those larger banks that perhaps the President of the United States is right, and they have an indispensable role to play in bringing these interest rates down, and both of us have to rise to our responsibilities here.

What do you think about that concept?

Mr. VOLCKER. First of all, I do not think the IMF legislation is justified as a means of helping the banks. I do not justify it in those terms. I justify it in terms of helping the country, helping the economy of the United States.

Senator SASSER. Well, the banks got us into this and if we do not help the IMF, they are going to suffer along with the rest of us. I mean, we are all in the same boat with them.

Mr. VOLCKER. I think that is correct; we are all going to suffer, and I would just let the case rest there. I think we would all suffer, and that is the only kind of justification you have for this kind of action.

So far as the lending rates are concerned, I do not think I can add to what I said earlier. I think those rates are high relative to current conditions, and the outlook that I foresee. I think they are coming down, and I welcome seeing declines in those consumer loan rates. I think they are headed in that direction, and I am not at all unhappy about seeing that.

RATIONALIZATION OF LARGE DEFICITS WITHOUT INFLATION

Senator SASSER. One final question, and it will be very short, Mr. Chairman. We have talked on many occasions about the large budget deficits being primarily responsible for inflation. Yet we have the anomaly here of the largest budget deficit last year, I suppose, in the history of the republic. I do not know of a larger one, even in wartime years. Yet we have inflation coming down, at its lowest level, you say, in 10 years, and we might even be able to take it back to the lowest level in 15 years. How do we rationalize that?

Mr. VOLCKER. You rationalize the large deficit—if rationalize is the right word today—to the extent it can be rationalized, not as good policy but because we are in the middle of a recession. The consequences of those deficits are quite different when you do not have a recession.

We can, in theory, have those large deficits without inflation. I am not sure the theory would hold in practice. What it means is you would have very little net investment in the economy, because the Government would be using all the savings. If you can imagine an economy operating successfully with the Government taking practically all the savings, you can sit on the money supply hard enough, in concept, so that you would not have any inflation. I think you would have pretty much of a mess in the economy under those circumstances. There are pressures emerging from the desire to finance the deficit that make it harder to control the money supply. In a sense, the influence is indirect, or it could be offset by other policy measures, but I do not know of any way of offsetting it that is at all consistent with the kind of economy you and I would like to see—a growing economy, with vigorous investment, and the kind of housing growth that Senator Biden is talking about. Those are just incompatible.

LOWER DISCOUNT RATE

Senator SASSER. How about lowering the discount rate a little more? Maybe if we lowered the discount rate another point—and I think you can justify that, Mr. Chairman, with this inflation coming down, and Chairman Volcker is optimistic it is going to come down more—why don't we lower it one more point and issue a strong statement to our friends in the banking world that we expect them to bring these interest rates down also? What is wrong with doing that?

Mr. VOLCKER. That is the kind of judgment we get paid to make.

Senator SASSER. If you would do that, I would throw a party in your honor, Mr. Chairman.

Senator RIEGLE. We will all be there.

Mr. VOLCKER. You have stated one side of the argument. The other side of the argument is whether that kind of action is consistent with the growth in money and credit, both in the short run and over a period of time, that is really consistent with my optimism about inflation and my relative optimism about interest rates coming down over a period of time. I do not want to exchange a possible party, much as I would welcome that, by you and Senator Riegle, for a lot of problems 2 months down the road——

Senator SASSER. We could even get Senator Metzenbaum.

Mr. VOLCKER [continuing]. So I have got to balance my current pleasures against my future problems, and that is what we try to do all the time.

I would note, as I have noted before—and some people have made a little too much out of this—that we reduced the discount rate in December, and the market rates did not decline.

Senator RIEGLE. Of course, we are not in December now; we are in February.

Mr. VOLCKER. I agree. We look at this all the time. We do not go to sleep, except at night.

Senator SASSER. That is it. Thank you, Mr. Chairman.

Chairman DOMENICI. Senator Quayle is next, but I am going to just ask one question here in-between, so I will get my chance here. Can you stay until 12:15, Mr. Chairman?

Mr. VOLCKER. Yes.

POLICY CHANGE WITH REFERENCE TO INTEREST RATES

Chairman DOMENICI. Some economists—while I will agree at this point, a small number, a minority—are suggesting that the economy could recover very rapidly this year, more than what the President estimates and more than what you estimate. I wonder Chairman Volcker, if recovery happened faster than most people expect now, would you immediately read that as having an adverse effect on inflation and change your policy with reference to interest rates, so as to cause it to be modified in a downward fashion?

Mr. VOLCKER. I would not express our policy in terms of interest rates under any condition. We are not aiming at a particular level of interest rates.

Chairman DOMENICI. Well, wait now. I hear you always say that, and I am one of your fondest admirers, but that is really not a true statement in the sense that you do not target it, but the things you do have an effect on the interest rate—OK?

Mr. VOLCKER. Yes.

Chairman DOMENICI. I mean, I am looking at your nonborrowed reserve in June 1982.

Mr. VOLCKER. I will accept that.

Chairman DOMENICI. All right.

Mr. VOLCKER. Everything we do has an influence on interest rates in the short and long run, sometimes in the opposite direction.

Chairman DOMENICI. So what would you do?

Mr. VOLCKER. We are not targeting interest rates. I cannot answer that question on the basis of just a single number of that sort. The administration puts out projections; the CBO does; obviously, private economists make their living putting out projections; the Congress asks us to put out forecasts. The danger is if people put too much weight on a particular forecast when the record is clear that the forecasts are no good, typically. The economy, last year, did not follow any of the forecasts by the administration, the CBO, the Federal Reserve, or private forecasters. When you look at those forecasts, you always ought to have a lively awareness of the range of uncertainty that exists around us.

I say that as a preliminary to saying that once the economy begins expanding, it is not at all impossible in any particular quarter or any particular two quarters—if you get an inventory movement, in particular; that is what tends to move the economy in the short run—to have a much larger GNP number for a period of time than the administration or the CBO now forecasts.

But, upon analysis, if you have got a big quarter stuck in that reflects a sudden change in inventory behavior, it may have very little policy significance. One could imagine other kinds of developments that would have policy significance. What we would be looking at, among other aspects, is whether things are going on in the economy that are consistent or inconsistent with continuing progress on the inflation side.

Chairman DOMENICI. So what you are saying is that if the present indicators that you are using with reference to inflation gave no serious evidence that there was an upward push on that, you would not drastically modify your monetary policies if we had exceptional growth in the next 8 or 9 months?

Mr. VOLCKER. You would have to look out into the future. You would look at those indicators, but you would have to look, as Mr. Hatch was suggesting in his line of questioning, at what is happening with the supply of money and credit. If that was looking excessive, or threatening to be excessive, in terms of the longer run outlook, we would certainly be concerned and want to do something about it.

Chairman DOMENICI. Senator Quayle?

CAPABILITY TO AFFECT INTEREST RATES

Senator QUAYLE. Thank you, Mr. Chairman.

Chairman Volcker, I will just briefly join in the chorus—I know you are tired of hearing it—about the concerns we have for real interest rates. I agree with your response to Senator Domenici and would like to follow up a bit. Everything you do do has an effect, an impact, on interest rates. I certainly believe that what you have done in the last 6 months has had a definite impact on bringing the prime rate down. I believe that you can have further impact on bringing the prime rate down. You certainly have the capability to affect interest rates. This is a historic situation where we have an 8-percent real interest rate—and it was 10 percent—we certainly hope that it goes down. A lot of people, I know, will be watching you, and I hope you can take some positive steps. I do not know what those steps may be. Some suggest a lowering of the discount rate. I believe that this unprecedented real interest rate is a tremendous problem that we have. We have talked about this before, and I just want to amplify and reassure you that my feelings have not changed a bit. I believe you understand and are certainly totally aware of the political implications and the political fallout if, in fact, we do not see these interest rates continue to ratchet downward, and particularly the real interest rate.

Mr. VOLCKER. I share the hope about interest rates, but let me disappoint you with my answer.

Senator QUAYLE. Are you going to tell me you do not have the power to bring it down?

INFLUENCE ON INTEREST RATES

Mr. VOLCKER. I said that everything we do has some kind of an influence on interest rates. It may not be in the direction that you think. It may not be all that clear and straightforward. In fact, it may be counter to what you would like to happen at some point.

What I had in mind when I said that is we may influence short-term rates by the immediate pressures we exert on bank reserve positions, but more fundamentally, over time, our influence on interest rates is going to be exerted indirectly, through the influence that we have on inflation and inflationary expectations. If we do something that runs counter to that, we are going to have an influence on the interest rates, all right, but it is not going to be in the direction that you want; it is going to jump up and bite you. If we try, in the short run, to control interest rates on the downside, when that is inconsistent with the broader need to control inflation, we will have an influence, but it is going to be precisely in the opposite direction from what you or we would want.

Senator QUAYLE. Well, we certainly do not want to get back into the inflationary cycle or inflationary economy that we experienced in the late seventies. I think that would be counterproductive. But I certainly do believe that your influence is not only indirect in how you are going to tackle inflation, I think there are probably a lot of direct things that can be done. I believe, quite frankly, that you have done some things over the last 6 months to see these interest rates come down. I only say, I hope they continue in that direction. Whatever tools and statements and private communications that you can make to your friends in the financial community—I just want to stress that this is a real problem and a real concern. If we see things start going the other way, there will be all sorts of political fallout that may be detrimental in the long run.

Mr. VOLCKER. I understand your political concerns, and I understand the political pressures, but let me just say—because, I suppose I need your help—that converting those pressures into something that is going to be counterproductive in terms of the very objectives that you and I would like to see would be a mistake. There has to be some understanding of that, because if there is not, we are not going to be successful.

I know there is very strong feeling up here, as we often put it, that we have some button to press, that we can really control those interest rates at a precise level, regardless of what else is going on. In that sense, we cannot.

IMPACT OF OIL PRICE DECREASE ON U.S. BANKS

Senator QUAYLE. You responded to Senator Gorton and perhaps others using the word, "frustration,"—that at times, you feel frustrated. We certainly also feel frustrated. I think that the single most frustrating factor is this real interest rate. Now, we have been talking about this for two years, and we kept saying, well, it looks like it is going to be temporary, but we still have it. It may be only 8 percent today where it was 10 percent before; on an historical basis, it should be 3 or 4 percent. That is a fact and we have had a certain degree of patience and tolerance from a political point of view.

But I have another question, entirely different from that. I want to know what you think the impact on some major U.S. banks will be with a $10 decrease in the price of a barrel of oil.

Mr. VOLCKER. A $10 decrease? I do not know what price of oil you have in mind that you are measuring that from.

Senator QUAYLE. Whatever it is today, and say in the next few weeks or months that it goes down, say, $10 a barrel—what kind of an impact would that have on major U.S. banks?

Mr. VOLCKER. I cannot judge it with any precision; I am not expert enough in that area. But a decline in the price of oil into the low $20 area, let's say, I think clearly would have a disturbing impact on major elements of the energy business, the drilling and exploration area. There is a lot of bank financing of that kind of activity, and I suspect there would be some impact. A more moderate decline, I do not think would have all that much of an impact.

Senator QUAYLE. Do you think that the decline in the oil is a good thing or a bad thing?

Mr. VOLCKER. Some moderate decline, I think, is a good thing in these circumstances. It is hard to take a view on the question of how big a decline without a view of the longer term outlook about the price. I do not think it does anybody much good to have a very jagged, downward movement in the price of oil, if it is just going to go up again 2 or 3 years from now as economies recover and oil demand expands and reserves are depleted and all the rest. A lot depends on what you think the longer term trend is, as to how deep a decline in the price of oil is desirable.

I do not think sudden changes that are simply going to be reversed are particularly useful, however nice they may be from a very shortrun perspective. I assume that some moderate decline would not have to be reversed, given the present situation and the foreseeable situation in the energy business for a considerable period of time. When the balance shifts between this being all favorable to its having some unfavorable aspects is a hard judgment to make.

Senator QUAYLE. I see my time has expired. Could I ask one more question?

Chairman DOMENICI. Sure. Go ahead.

DEBTORS' CARTEL

Senator QUAYLE. There has been a lot of discussion of a debtors' cartel, that the debtor nations would get together and form some sort of a cartel and not pay on their loans. Do you fear this? Do you think this is a possibility?

Mr. VOLCKER. Let me say the best evidence we have on that is in the behavior of the debtors. The debtors have been, I think, in the forefront of wanting to do things, recognizing legitimately and accurately, I think, their own longrun interest in preserving their credit worthiness. They have been in the forefront—when they finally faced up to it—of taking actions not of the nature you describe, but rather actions designed to protect their credit worthiness. It is worth pointing out the extent of those measures that they are taking, because I think it is directly responsive to your point. You are struggling with a deficit here, an important and critical question for the American economy, and you wonder whether you can reduce spending enough, raise taxes, or whatever. Put the challenge that you are presented with—and I do not want to underestimate it at all—in the perspective of what Mexico or Brazil or Argentina have been asked to do. They have been asked to cut their deficits—larger deficits in proportion to their economies by a margin of about 100 percent—in half in a year—not to worry about recessions or the economy or whatever, but just cut it by 50 percent relative to the GNP in 1983. It is as if you were asked to cut the deficit immediately by $100 billion; it is much more than that, because their deficits are bigger. Even if you were to agree to enact all those measures in the next 6 weeks to cut that deficit by $100 billion, you are not doing as much as they are doing. That is what they have basically agreed to do, and it has short-term impacts on their economies, without question. They are already poor countries. They justify this by the fact that preserving their credit worthiness, preserving their access to the markets, is worth it; otherwise, they would have to have an even more severe adjustment, with much less prospect for restoring growth.

Why do these countries have the problem that they do? I think it is fair to say they all had nice growth—Mexico and Brazil in particular had very high rates of growth for quite a few years. Financially, they were getting in more and more difficulty with external borrowing, bigger and bigger deficits at home. But it was nice while it lasted. They are human beings, and they were very reluctant to face up to the problem. They had political problems, and they did not want to take any risk of damaging this nice growth they had; they had elections approaching. The net result was that the adjustment in the end had to be much more severe and difficult than if they had dealt with the problems at an earlier stage. I think we are at that earlier stage, in some sense.

Senator QUAYLE. Thank you.

Chairman DOMENICI. Senator Grassley?

Senator GRASSLEY. Chairman Volcker, I have two unrelated questions, and then I want to get back to the question that I was discussing at the time I broke in on the chairman.

No. 1, do you want the President to reappoint you to the Chairmanship of the Board?

Mr. VOLCKER. That is a question, as I said before, that I am not prepared to discuss in public right at this juncture.

IMPACT OF INTEREST WITHHOLDING ON RATE OF SAVINGS

Senator GRASSLEY. Well, I only ask it in the vein that not only, one, am I interested, but No. 2, I think it might have some sort of a signal on what is going to happen in the future to the economy—and I do not say that in a negative vein.

Second, is there any evidence from your research in your agency that withholding on interest income is going to have any detrimental impact on the rate on savings and then, in turn, on our economic recovery?

Mr. VOLCKER. I do not think we have any evidence that bears on that point. I would not expect it to have a big impact.

Senator GRASSLEY. OK, that is your personal judgment. Maybe I could ask, if you do, then I would like to have access to that.

Mr. VOLCKER. If we have anything, I would be glad to supply it to you.

[The following was subsequently supplied for the record:]

The Federal Reserve Board staff does not have any studies of the effect on saving of the withholding of tax on interest income. The Treasury is still reviewing and modifying the regulations to implement this provision of the tax code. The effect on saving would occur through the effect on the after-tax rate of return. The after-tax rate of return for a law-abiding taxpayer income that would otherwise have been compounded before being subject to tax. This effect is likely to be small, especially in view of the current plan to permit withholding from accounts having transactions features, such as NOW accounts and money market deposit accounts, only at the end of the calendar year. These accounts are likely to be an important vehicle for saving (apart from pension plan saving) by moderate income households. Very high income households, whose saving would be much more likely to be in the form of financial market instruments are, of course, subject to the requirement of quarterly estimated tax payments.

GREATER INVESTMENTS IN MORE SECURE GOVERNMENT SECURITIES

Senator GRASSLEY. Then, let us assume that the answer you gave me to my comment earlier is that, no, your regulators or your examiners or anybody in your agency who could have influence on local banks are not taking a different approach on examining and then hence, not contributing to a reign of terror that is going on in rural America as far as what banks will do with their lending ability. Let us assume that that is true, and yet the facts that Chairman Domenici gave you are true—there are greater investments in more secure Government securities at a lower rate of return, and that is causing somewhat of an impact upon lending by independent banks in rural America. Isn't there anything that your agency can do to discourage that trend, assuming that the continuing lending to local businessmen and farmers is better for the economy than such an overwhelming trend to Government securities on the part of banks for investment?

Mr. VOLCKER. I do not think this is the time for banks to run for cover. I do not think it is a time for examiners to run for cover, as my earlier response indicated.

Senator GRASSLEY. Well, isn't this the environment, though, that we are in, and so shouldn't you be doing something about it, as long as you have concluded that it is not the time——

Mr. VOLCKER. I think there is a danger in this environment of that kind of response. I think you see it quite clearly in the international area. I suppose I should say at this point that some of the congressional concerns that have been expressed about this are, at one level, quite legitimate and I share them. How do we improve our supervisory and regulatory apparatus to make sure that we and the banks are properly evaluating risks in this area? That is a perfectly legitimate, reasonable question, but it can easily go further and take the coloration of punitive action, restrictive action that only contributes to the very atmosphere that you and I are expressing concern about.

Senator GRASSLEY. OK, so admitting it is a gray area, it is a fine line, it is an area that when you tread into it, you have to tread into carefully——

Mr. VOLCKER. That is correct.

Senator GRASSLEY. You just do not avoid it, if you recognize it as a problem. And I think your statement said you did recognize it as a problem.

Mr. VOLCKER. I think in the international area, we have quite clearly recognized it as a problem in all our public statements and pointed out again and again to the banks that it is in the general interest that there not be a sudden, mass withdrawal from international lending.

Senator GRASSLEY. Well, are you pursuing, or can't you pursue the same course of dialog in the domestic area with the independent banks, and particularly in the nonmetropolitan areas of our country?

Mr. VOLCKER. To the extent this dialog makes the point, I hope we are making it.

Senator GRASSLEY. So you are trying to make that point, then; is that what you are saying?

Mr. VOLCKER. I think I have tried to make that point in responding to you.

MAINTAIN CONSISTENCY IN EXAMINATION AND SUPERVISORY POLICIES

Senator GRASSLEY. OK, but I mean, this has been the policy of the Board, then, for a considerable time; I mean, it is not starting now because Senator Grassley asked a question, obviously.

Mr. VOLCKER. No. Our policy is certainly to maintain a consistency in examination and supervisory practices. If we should be tighter in some sense on foreign loans over a period of time, we should be. But we should not try to follow the cycle or aggravate cycles by being more restrictive in a recession.

Senator GRASSLEY. OK, so you are being consistent, and I think that that is legitimate. On the other hand, prior to this, you said that you suspect that there is a problem in the area of banks withdrawing. OK, if you stay consistent, then, you really cannot answer positively to my question that there is anything that the Board is doing in the domestic area, the same as you are doing in the international area, to help us with this problem.

Mr. VOLCKER. All we have done in the international area is to make the point. Let me distinguish between two events. What I was basically addressing myself to—what I think your question was addressed to—was the regulators terrorizing the banks. Speaking for the Federal Reserve, I have inquired and have received the answer, "No, we are not," I think the inquiry itself indicates that I do not think that would be appropriate.

Banks, entirely independent of that, making their own judgments based upon what they see going on in the economy or their local community, are going to have reactions. I hope those are not overreactions. But how they react to their own perceptions of what they see going on in their own communities is a different matter.

Senator GRASSLEY. When I think of policy, beyond dialog, it would seem to me like if there is too much of a transference of money that would go into loans for local business and agriculture—and that is coming into Government securities—and you think that that sort of trend might not be good for the economy, then it seems to me like you would be beholden to changing that, not in the sense of hard policy or making a big deal out of it so that people panic, but so that that transferal of wealth does not occur from rural America to the Government or to the larger cities. We are talking about availability of credit.

Mr. VOLCKER. I am not sure what you are suggesting we should do. We do not want to, and do not——

Senator GRASSLEY. I do not think I am in a position to suggest what you should do, but I guess I can suggest that there is a problem. You have said in your statement to me that you recognize there is a problem. You talk about consistency of pattern in——

Mr. VOLCKER. What we can do is be consistent in our supervisory and examination policies. We are trying to do that.

Senator GRASSLEY. OK, but that is just the maintenance of the status quo and not anything to retard what you have admitted could be a dangerous trend.

Mr. VOLCKER. But these things in the end, in a specific case, depend upon lending to a particular person at a particular rate under particular terms. That is a decision we cannot get into, and that is, in the end, where these judgments are made.

Senator GRASSLEY. Thank you.

BANKS OVERREACTING TO PORTFOLIOS

Chairman DOMENICI. Mr. Chairman, I believe the banks are terrorized by their own portfolios. My concern is that they are overreacting to the portfolios.

I think they are looking out there at a bad economy, and they look at what might very soon go on the bad debt list, and I think they are overreacting in the sense that they do not want to take any of the risk.

That is how I evaluate it. I do not know how we get around that. But I really think——

Mr. VOLCKER. That is, in fact, the danger to which I was alluding.

Chairman DOMENICI. And I do not know that they ought to be in a position where, when they have a direct potential in helping us get out of the problem—which, the more you look at it, it is very, very real, their potential for helping out of it—I do not know how we objectively analyze their responsibility to take some of the risk. But I am convinced that for the most part, they are not going to take very much of it under present circumstances.

Mr. VOLCKER. Obviously, we do not want to be in a position—we cannot be and will not be in a position—of telling a bank, "Make a loan that you consider a bad loan." We cannot be in that position.

Chairman DOMENICI. I understand. The problem is that they are turning down good risks at the local level, for the security of short-term turnover money that they put with you or that they put with the Feds, on their overnight, quick turnover. They are putting billions in rather than lend it out, because of their own portfolios. And somehow or another, it appears to me that they are going to have to share the risk in the recovery some way.

Mr. VOLCKER. I am hopeful that that may be changing. We went through a couple of years when rural banks, in particular, found it convenient and profitable to shift extraordinarily large amounts of money into the central money market to make a lot of money on Federal funds.

Chairman DOMENICI. Yes, sir.

Mr. VOLCKER. In the process, they became very liquid. They are now, by and large, much more liquid than they were several years ago. They are also taking on higher cost deposits, and the Federal funds rate is way down, so the economic incentives have shifted in the direction where I think they have got to look a little harder in their local communities for lending opportunities.

The record on consumer loans I might note, during this period, has been exceptionally good in terms of riskiness. The losses have been very low on consumer loans during this period.

Chairman DOMENICI. Senator Exon?

Senator EXON. Thank you, Mr. Chairman.

FOREIGN LOANS RENEGOTIATED AT HIGHER RATES

Mr. Secretary, I know that you have been involved in the renegotiation of loans with Mexico, Brazil, Argentina, and some other nations. What basically is the interest rate at which these loans are being renegotiated?

Mr. VOLCKER. Renegotiated rates have been raised. There is no question about that. The rates are related to some kind of a floating rate, usually both the prime rate and the Eurodollar rate. And I do not recall exactly the interest rates negotiated on the restructured and new loans, but they would approximate the Eurodollar rate plus 2 percent, plus 2¼ percent, something like that.

Senator EXON. Well, for a layman like me, can't you translate that some way into an interest rate that I can understand?

Mr. VOLCKER. The prime rate, as has been repeatedly pointed out here today, is 11 percent; if it is related to the prime rate plus, the rate is going to be 12, 13 percent.

NEBRASKA FARMER LOANS VERSUS FOREIGN LOANS

Senator EXON. Isn't it true that these loans with other countries are being basically negotiated at an interest rate lower than what a Nebraska farmer would be required to pay today?

Mr. VOLCKER. I think the rates would probably be comparable today. I think there is no doubt that the older loans, the loans that are being refinanced, are less than the Nebraska farmer had to pay—I do not know just what a Nebraska farmer is paying today. The mortgage rate posted by thrift institutions today for fixed-rate mortgages—and these foreign loans are not fixed-rate mortgages, they are not 30-year loans, so they are not directly comparable—the latest average rate on new, 30-year, fixed-rate mortgages is just over 13 percent.

Senator EXON. Are there very many such loans being made, or are they not mostly being made on a flexible rate or optional rate for 1, 2, or 3 years in the future?

Mr. VOLCKER. Compared to 5 years ago, a lot are being made on a flexible rate basis, but the proportion being made at fixed rates is about 60 percent. More than half are still being made on a fixed-rate basis. The biggest portion of the fixed-rate basis loans are the FHA programs or other government-related programs, where the mortgage is placed in the market—in the bond market, basically.

FOREIGN LOANS MORE COMPARABLE TO FLOATING RATE MORTGAGE

Senator EXON. The point I want to make is that as we look forward to appropriations on the IMF and other such recommendations by the administration, I am sure that the question is going to be raised that if we are making loans at whatever the rate is to those countries—that everyone recognizes are a questionable risk today—at a lower rate than to a farmer in Nebraska, the question is going to come: why, and what sense does that make. I am just bringing that to your attention.

Let me go on——

Mr. VOLCKER. In the interest of clarifying the point further, these foreign loans would certainly be more comparable to a floating rate mortgage, because they are floating rates. Today, on a floating rate mortgage, a flexible rate mortgage, the initial lending rate that the borrower has to pay would be typically, I suppose, in the 11 or 12 percent area.

Senator EXON. Would you not generally agree that a responsible farmer in Nebraska should be able to borrow money at a lower rate than Mexico, given the risk involved?

Mr. VOLCKER. You would have to describe the particular farmer in Nebraska, I suppose. Are you talking about one who has a lot of equity, and so forth——

MARKET DECIDES RISK ADJUSTMENTS

Senator **Exon**. Assume it was a well-financed, rich, wealthy U.S. Senator like myself, who has a good credit rating—and I am not rich and I am not well-financed, but let us assume that, for the sake of discussion. Do you think that if I went back to Nebraska, I should have to pay a higher rate if I offer good security than Mexico?

Mr. **Volcker**. I suppose the answer to that should be that the market decides these relative risk adjustments, but——

Senator **Exon**. That is one of the problems that we have. The market is deciding, and I think the market is deciding unfairly.

Mr. **Volcker**. I am not aware in any significant amount whatever, of loans that have been made to foreign countries by private institutions for 20 or 30 years at fixed rates. That kind of loan simply is not available to a foreign country, in recognition of some of the risks——

Senator **Exon**. Nor, Mr. Chairman, are they available to the farmer in Nebraska today.

Mr. **Volcker**. They are less than they used to be.

TOO CONCERNED ABOUT INFLATIONARY PRESSURES

Senator **Exon**. Let me go on to another matter. In your statement you said, "Looking back, the gains in the fight against inflation are striking," and then your testimony says that, "The U.S. economy has become increasingly integrated into the world economy over the years. In contrast to most earlier recession, exports dropped sharply in 1982, reflecting both recessionary tendencies in the rest of the world and substantial appreciation of the dollar in 1981 and 1982." Yesterday before this committee, we had some testimony from leading agricultural experts, and I think it is fair to say that there was a witness or two who specifically said that the appreciation of the dollar around the world was the main reason, among others, that we were having for the dramatic drop in our agricultural exports. And they blamed—at least some of them blamed—the fact of the appreciation of the dollar tied in with the gains against fighting inflation.

Now, I am not sure that I agree with their thesis, but one thesis that came out very loud and very clear was that with the international crisis that we are facing in the monetary situation, maybe we are being too concerned about inflationary pressures. Maybe we should be more concerned about stabilizing the international monetary situation, return to some acceptable level of exports from this country, and not be so much concerned about inflation. Now, I am not saying I agree with that, but I thought it was an interesting commentary, and I want to know what your views on that are.

Mr. **Volcker**. My view is we cannot go home again; that used to be a nice theory—for a while, it may have been the practice—that a little bit of inflation was a tolerable price for other things, like expansion, more exports, and all the rest. I think that was, stated or not, the kind of prevailing sense of policy for many years.

I think you are in a fundamentally different situation when you have gone through more than a decade of accelerating inflation, because the benefits of inflation—for a while they may have been real—depend upon the fact that people do not expect the inflation to happen, or at least not to the degree that it happens. Once people get sensitized to inflation to the degree they are now, unfortunately, I think the danger is all too great that they will anticipate even more inflation than you say you are willing to tolerate as a matter of policy.

If they do that, you will get quite different reactions in the market; in financial market terms, the interest rates will accelerate faster than the inflation rate. We see the other side of that slippery slope right now, when confidence has been undermined to the degree that interest rates are very slow to come down, precisely because people fear that scenario.

If you want to discuss with me—you, collectively—most of the morning, why real interest rates are not lower, and then at the end say, "Well, maybe we ought to have a little more inflation and solve our problems," I must say that is precisely what the market is telling us, is one of their fears. It seems to me totally inconsistent with getting the interest rates down so the Nebraska farmer and everybody else can enjoy the lower interest rates.

OVERREACHING IN TRYING TO REDUCE INFLATIONARY PRESSURES

Senator EXON. Well, my time is up. Let me just say this, Mr. Chairman. As you know, nothing is all black or all white. There are gray areas. I think what the witnesses yesterday were saying to us was that while we think we are trending in the right direction, that if we are going to make sure that the world economy improves, and if we are going to make it possible for these countries to repay their debts, that maybe we have overreached—I think maybe that is a statement, and the Chairman heard it—maybe we are overreaching in trying to reduce the inflationary pressures. Maybe we have gone a little too far a little too fast, without being critical of the direction.

Mr. VOLCKER. That is the balance we have to try to reach. You can argue all the gray areas, quite correctly. I want to emphasize I do not think we are going to be successful unless we maintain the general framework and context of moving against inflation; otherwise, not only will the inflation itself be a problem, but I think we cannot control the market reactions that will be adverse to the very thing we are trying to achieve.

Senator EXON. Well, since I want to be on the side of the Lord and the angels, I agree with you on the last part of your statement.

I thank the chairman, and I thank the chairman of the Committee.

DEFICITS PREDICATED ON MONETARY POLICY

Chairman DOMENICI. Chairman Volcker, while you might quibble with my opening remarks as to the percent, the 1980–1981, 39 or whatever it was, we will redo it with consensus economics, and I assure you that it is going to turn out over 50 percent. Over 50 percent of the out-year projected deficits are predicated on monetary policy, not legislative changes here—but I just want to ask you this simple question. Do you agree that monetary policy has played a very important role in increasing the size of the budget deficit—yes or no?

Mr. VOLCKER. No.

Chairman DOMENICI. Why not?

Mr. VOLCKER. Because I do not know what deficit you are looking at. If you are looking at a 5-year perspective, If anything, we have probably helped improve things in the long run, because my conviction is we are helping the economy be healthier over a period of time.

Chairman DOMENICI. Well, it is not healthy yet.

Mr. VOLCKER. We can have another discussion about what monetary policy did or did not contribute to the recession. The recession obviously contributes to the immediate budget deficit.

Chairman DOMENICI. And monetary policy did not have anything to do with that?

Mr. VOLCKER. I think that the course we were on would have produced more economic difficulties, so you always have to say compared to what.

Chairman DOMENICI. Well, you know, I am not your enemy; I am your friend. But I——

Mr. VOLCKER. I understand, but I am afraid the simple answer to that question leads to the wrong policy conclusion.

RATE OF CHANGE IN NONBORROWED RESERVES

Chairman DOMENICI. Well, let me ask you a question. In June 1982, your nonborrowed reserve was negative 2.3. In July, it was positive 13.1. In August it was positive 15.9. Now, I just want to ask you what caused you to make the change between June and July?

Mr. VOLCKER. Those figures do not seem quite——

Chairman DOMENICI. That is the rate of change, the rate of change.

Mr. VOLCKER. The rate of change in nonborrowed reserves?

Chairman DOMENICI. Right, percentage change.

Mr. VOLCKER. When you take it from month to month, a lot of technical factors enter into that calculation. The figures I remember for December were rising very rapidly; in January, they were practically level. In the short run, a lot of things enter into those.

Let me answer the question in a way I think is really more meaningful. If you look at the marginal pressures on banks—which would be not nonborrowed reserves but borrowed reserves, in the jargon of the trade, how much banks were borrowing or forced to borrow from the Federal Reserve, you would find that that figure went down in precisely the period that you are talking about, from the spring into the fall, continuing into the present. That certainly reflected a judgment that under all the circumstances, including the performance of the economy, the financial strains in the economy, analysis of the money supply figures and velocity, to achieve our policy objectives, restraint on bank reserves could be reduced. I guess I answered your question. Why did it change? It changed because our analysis——

Chairman DOMENICI. We had not done anything in the Congress yet, by way of fiscal policy change. That is why I asked the question.

Mr. VOLCKER. During that period—and relating it to the decline in interest rates—you did do your fiscal policy package last summer. I do not remember exactly when it was, but it was about that time; in fact, my memory is that that action at that time helped to precipitate the sharp decline in market rates.

Chairman DOMENICI. Well, actually, the 3-month T-bills had come down from 12.1 to 9 before we took any——

Mr. VOLCKER. Before you had concluded your action?

Chairman DOMENICI. Yes.

Mr. VOLCKER. When did you conclude? My memory is you took some action before you went into recess.

Chairman DOMENICI. Well, we did not have any of the legislation passed to carry out the budget resolution.

Mr. VOLCKER. But you had the budget resolution before you went into recess in early July—I am going on memory.

Chairman DOMENICI. We had it before August.

Mr. VOLCKER. My memory is that that was a market factor at the time. But I think the most important factor—and your action was, of course, consistent with it—was that by that time we had had 6 months of better price statistics than had been anticipated. We also had the failure of the economy to recover, as many people had been projecting earlier. You put together all those factors, including less pressure on bank reserve positions, and you have a very strong and active boom in the bond market that happened to coincide at that time with sharply rising stock prices; the expectation shifted very rapidly from high interest rates to much lower interest rates. As late as May and June, as I remember it, some of the market pundits were projecting higher interest rates later in the year. That atmosphere changed very drastically, for a variety of reasons, within 2 months, and we certainly did not impede that process.

FISCAL POLICY CHANGES

Chairman DOMENICI. Mr. Volcker, assume we did not have a budget process—we have gone through recessions and recoveries without it—and while Presidents have from time to time, even before the budget process, submitted multiyear budgets, Congress has never had a multiyear budget until the budget process. What if we did not have a budget process at all? I am fully aware of your statement that you have made heretofore that you do not want to suggest that there is a simple trade-off, as sometimes suggested, between future budget policy and current monetary policy, nonetheless indicating that the long-term trends are important. If we did not have a multiyear capacity to do something, what fiscal policy changes would you expect Congress to make to be consistent with your continued growth in monetary policy? What would you want them to do?

You see, what I am confronted with——

Mr. VOLCKER. I am quite clear about what I would like to see Congress do. I am a little confused about what you mean by the absence of a budget process.

Chairman DOMENICI. Well, what we have to do is put down on paper a 5-year projection, the last 2 or 3 of which are highly speculative; we are expected to ask Congress to do a number of things this year that obviously have impact on 1984, but we are continually told that we have to do some things that have a dramatic impact on 1985-1988.

Now, we did not even have this kind of tool when Arthur Burns was chairman, your predecessor for years. We had it a year at a time, with a few changes made here and there in the law. And yet we are being asked to put this all down in one, and in some way, set a 5-year pattern that satisfies those who are partners, such as you, on the monetary side.

So let me just be specific. Would a $185 billion deficit in 1984, as recommended by the President, be all right?

HOLD STRUCTURAL DEFICIT STEADY

Mr. VOLCKER. Let me look at the breakdowns again as between structural and cyclical. When you are forced to look out—which is desirable—for a series of years, I think you have to try to remove yourself from the business cycle, because those projections are inevitably going to be flimsy anyway. I have the Budget Bureau's projections in front of me. I would like to see that structural deficit—their figures show it is $70 billion now—held steady or in a gentle declining trend; with that, you would have made a very great improvement. It really should be more than that. The administration shows bigger deficits. The administration's proposals are bigger than that, as I recall them.

Chairman DOMENICI. That is correct.

GENERAL MAGNITUDE OF ADMINISTRATION PROPOSALS CORRECT

Mr. VOLCKER. That is why I said the general magnitude of the administration proposals seems to me correct. In terms of what I would like to see you do, by the time the administration gets to 1986, I think they are in the right general magnitude. Their deficit-reducing measures are $43 billion, roughly, in 1984; $59 billion in 1985; and then jump up in 1986. I would like to see some of that 1986 effective action brought forward.

Chairman DOMENICI. Now, you note, though, that if you are looking at CBO's versus the administration's, with the same policies, they have a lower deficit in 1984 and 1985, but they have a larger deficit in 1987 and 1988, with the same policies in effect.

Mr. VOLCKER. Yes. I think you should conclude from this that, as you point out, all these figures are filled with a degree of uncertainty as one looks ahead. But what is unambiguous about any of these figures is that they are very big and that you have to do something on the order of magnitude that the administration is proposing. I just raised the question about the timing. But all the figures point at that general magnitude, and I do not think anybody can be more precise than that. When you get out to 1986-1987, unfortunately, you cannot judge, but, of course, you do not have to judge yet because there is some time that passes between now and then.

Chairman DOMENICI. But you would not——

Mr. VOLCKER. But, as you say, you have tools now that you did not have before. In one sense, you have the whole committee apparatus—you have the CBO and all the rest. This has been vastly expanded. You did have longer term forecasts before. What is so strikingly different—and it affected behavior earlier—is that earlier, whether we were in a recession or not you looked ahead and said, "We are going to have a great fiscal dividend. The budget is going to go into surplus. This is our margin for new programs, or this is our margin for reducing taxes." That was the analysis for 15 years. Of course, any surplus was more than spent, but there was still some reality to it.

Now you face the absolute opposite reality. There is no fiscal dividend, there is no margin for spending more or for reducing taxes. The only question is the precise degree to which you have to go in the other direction. You have greatly sharpened the tools by which you can approach it, but I think in terms of having some sense of what the long-term outlook was, you had it then. You did not have it precisely, you did not have it as carefully worked out, but it was there.

MIX OF RESTRAINT ON OUTLAY AND REVENUE SIDES

Chairman DOMENICI. The mix of restraint over the next 5 years on the outlay side is about 60; the revenue side enhancement or increase is about 40. Aside from what year you ought to do what, is it relevant whether the split between the two is in about that percent or not, or does it matter?

Mr. VOLCKER. I think it is relevant in a long-term outlook. You have a basic situation where Government expenditures are rising faster than the GNP—not taking it year by year, but over this 5-year period as compared to the earlier 5-year period. Revenues are holding fairly steady. You had a great debate, the Nation had a great debate, a couple of years ago about the relative merits of cutting taxes or increasing spending.

I agree with the general conclusion that from an economic standpoint, it would be better off to have 100 percent on the spending side. As a practical matter, I do not think you can do that. But I do not know what I can contribute to the question of what the proportion should be, because there you really do get into a question of how big the defense program has to be, what the social expenditures must be. From an economic standpoint, it seems to me, if it was 100 percent on expenditures, it would be better, but that is going to conflict with other priorities, which you obviously have to take into account and should take into account. Just how that split should work out, I do not think I have a lot to contribute—except that from an economic standpoint, the more that is on the spending side, the better.

Chairman DOMENICI. All right. So you would conclude at least that if there is a tendency to cause that mix to be preponderantly taxes as compared with expenditure cuts, that would not be——

Mr. VOLCKER. Yes; the more you go in that direction, from a general economic standpoint, the worse it is.

DEFICIT OF 2.5 PERCENT OF GNP

Chairman DOMENICI. Considering the nature of the deficit that we are confronted with over the next 5 years, is the President's goal of getting the deficit down to about 2½ percent of GNP in 1988—is that moving in the right direction?

Mr. VOLCKER. It is obviously moving in the right direction. I do not like to feel that a deficit of 2½ percent of the GNP in a good business year is the norm. We should have a surplus in those years. But considering where you are starting from, obviously, it is moving in the right direction.

REDUCING THREAT OF LARGE STRUCTURAL DEFICITS FAVORS CURRENT INTEREST

Chairman DOMENICI. If we were able to produce a policy statement that got us that far with reasonable certainty, based upon the economic assumptions made, would that budget policy be consistent with your statement here, that even though there is no simple trade-off, reducing the threat of large structural deficits out to the end of the decade would have a favorable effect on current interest rates?

Mr. VOLCKER. Yes, because I think the current expectation is much larger than that, so if you can produce a really credible proposal on that order, it would be very encouraging. You emphasized—and there probably is some kind of a trade-off, too—that it is not just what you say the deficit is going to be in 1988 that is important, but—I suppose more important in some respects—what actions are actually going to be taken that are believable to push you on that road. That is the skepticism you run into time and again in the markets; you can present the scenario, you can even include in that scenario the kind of measures that will have to be taken over time to reach it, but it only becomes fully credible and has a direct impact on the market when the actions are there. You will not be able to take all the actions, I presume, to produce that result, but you can begin getting on that road in a very clear way. That certainly does fit in, compared to where we stand now, with the direction that I am talking about.

Chairman DOMENICI. From what I can gather, though it might be complicated by many other facts, it appears to me that fiscal policy, in terms of having a direct impact on our growth, has more of a long-term impact than monetary policy changes. Do you agree with that?

Mr. VOLCKER. Yes; in a sense, I think what you may be thinking about is the impact on investment over a period of time——

Chairman DOMENICI. Yes.

Mr. VOLCKER [continuing]. Which is really, in the most simple or general kind of analysis, going to be controlled by fiscal policy and not monetary policy, because you are going to control how much of our savings goes in the direction of Government rather than in the direction of investment over a longtime horizon.

MONEY MARKET TAKES INTO ACCOUNT EXPECTATION OF LARGE DEFICITS

Chairman DOMENICI. Do you think that the money market expertise as a package has already taken into account the expectation of large deficits between 1983 and 1988?

Mr. VOLCKER. In a general way, but it is very hard to judge precisely to what degree it has been discounted. Certainly, when you talk to people in the money markets, they put a lot of weight on those kinds of numbers in a very general way and express a great deal of skepticism as to how much they will actually be brought down. But I am not sure whether the full enormity of a $200 billion-plus deficit in a really good business year has hit them. In a general way, yes, that is the number they have in mind.

Chairman **Domenici**. It seems to me they are far more aware than they were 10 or 12 years ago.

Mr. **Volcker**. I think that is certainly true. They are preoccupied with this because we are in this basically different situation.

VALUE OF THE DOLLAR

Chairman **Domenici**. My last question has to do with the value of the dollar, which is kind of tied up in all this. You are aware of the penalty that our export markets of all types are paying because of the high value of the dollar. Is it your—whatever you have to do with it, is it your policy effort now to reduce the value of the dollar in world exchange markets?

Mr. **Volcker**. I would not put it as a policy objective directly to reduce the value of the dollar. That is kind of a dangerous approach. Generally, I like a strong dollar, but I would agree that this is rather exceptional in the past couple of years, and it has not been healthy having it go up that high that rapidly.

But I would not adopt depreciating the dollar as a particular policy objective .

Chairman **Domenici**. Well, are you doing things——

Mr. **Volcker**. I think it has been rather abnormal.

Chairman **Domenici**. Are you doing things, taking actions that will make the dollar become even more super-dollar, or are you——

Mr. **Volcker**. We certainly are not deliberately doing so, but let me make an important observation in that connection from your point of view. When we have these kinds of deficits and we talk about the domestic impact on real interest rates, another way of approaching that same analysis is to say you are putting tremendous pressure on the supply of domestic savings. What you are going to do is attract savings from abroad. You attract that necessarily through a current account and trade deficit, because you cannot attract savings from abroad without a deficit.

The way that works out in the marketplace is in an abnormally high dollar. It is this kind of mix of fiscal policy and monetary policy that tends to put abnormal pressures on the dollar, because you have to suck savings in from abroad. Potentially, looking ahead, that becomes an acute consideration, not so much in the midst of recession again when the private investment demands are weak, but when the private investment demands are strong. Then you have the Government, you have business, you have the consumers, you have the homebuyers, all out there competing for money; they are going to tend to suck it in from abroad, and that is going to put pressure on the exchange rate and damage our export position. You take it out on the weak export sector.

Chairman **Domenici**. If we are unable to put together a multiyear budget that offers us some reasonable hope of a deficit trendline reduction, what would you see as the consequences?

Mr. VOLCKER. I think all those threats that people in the market talk about, of the recovery running into limits at an early stage because of pressures on the money market, pressures on investment, pressures on the capacity of savings are obviously going to become even more real than they think they are now. I think this is the largest single threat—although not the only threat—to what I basically think, after an agonizing, confusing period, can be a period of the beginning of a very long period of recovery and disinflation. I think there are a lot of good reasons to think that that can be the outlook for the 1980's.

But when I list the factors that could destroy that outlook, I think this has to rank as No. 1.

MONETARY POLICY HAS INFLUENCE ON ECONOMY

Chairman DOMENICI. My last question is, we have had 4 years, basically, of no growth in the American economy. You do not believe that monetary policy has played an important role—in fact, we have not had any real growth for 4 years——

Mr. VOLCKER. I think monetary policy has obviously played a role and an important role in the particular performance of the economy, the timing of what has happened, for good or bad—the inflation rate, on the good side. But I also believe that if monetary policy had done nothing—or, to put it a different way, if monetary policy had accommodated more inflation—we would also be sitting here and saying, "Why isn't the economy growing, what is the matter with investment, why are interest rates in the 20-percent area?"

There was no easy way out of the situation that we had. I think the longer that situation proceeded, the more we were riding for a still bigger fall. That is the simple point that I would make: there was no policy course that could produce a painless easing of the inflationary pressures, a smooth growth in the economy. I do not mean to suggest that monetary policy had no influence. What I mean to say is that there was no policy course that could get us out of the kind of problems we had without difficulty and pain.

Chairman DOMENICI. Well, Mr. Chairman, I want to again thank you.

Senator EXON. Mr. Chairman, I have a few questions.

INTEREST RATES AFFECT POTENTIAL GROWTH IN ECONOMY

Chairman DOMENICI. Oh, excuse me, I did not see you, Senator. I frankly believe that the monetary policy and your actions are going to be extremely important in terms of the recovery. I started new at this chairmanship a couple of years and a couple of months ago. I have now concluded that the one thing we have all found out is that interest rates have more to do with the potential growth in this economy than many of us thought before. I assume you knew that all the time.

Mr. VOLCKER. Yes.

Chairman DOMENICI. I guess some of us did not. I just do not see us getting out of it unless that is clearly understood by everyone. I wish we could make a commensurate, binding commitment for a 5- or 6-year fiscal policy, so that you would feel more free in terms of the monetary policy and interest rates. But I guess what I am concluding that I am afraid, that if we can only do a little bit, that signs out there of just losing the entire industrial base as we go through this wrenching may be far beyond what we expected. I think that is as much on monetary policy's shoulders as it is our ability, considering this is a democracy, and we have to operate that way. You do not, because we immunized you from it to some extent. I think and urge that you understand that we cannot ask that way, even if we wanted to, up here. It is going to be a difficult struggle. But we need more than a bending over on your end to understand your role, since it is kind of you and a few people who make some of those basic decisions, as compared with us. We have 100 Senators and a huge number of Congressmen and all kinds of procedural problems that inhibit us up here in terms of doing what we have to do.

Mr. VOLCKER. We are going to try our best. I think we are aware of the important influence of monetary policy. But I just have to reiterate one basic point. I appreciate and sympathize with your problems. I know no one has worked harder on this than you have. No one is trying harder; no one could ask for more. But we simply cannot, by monetary policy alone, whatever we try to do, solve problems that arise from other sectors of the economy. We do not have that kind of command. We cannot solve problems that are not solved up here.

Chairman DOMENICI. Senator Exon?

BALANCED BUDGET AMENDMENT

Senator EXON. Thank you, Mr. Chairman.

Chairman Volcker, you have been very patient, so I am going to be very brief. The first question, maybe you can answer with a yes or no. Given the realities of the situation, and given the projections of the budget deficits now and in the out years by the administration, do the Fed and the money markets consider the President's balanced budget amendment a possible reality or a joke?

Mr. VOLCKER. The Federal Reserve has no position on this. I have expressed a position on it before, that I sympathize with the objective. I have not quite seen how it would be practical to incorporate it into any constitutional amendment that would not be likely to do more harm than good. But I say that with great reluctance, because I think we need more discipline on the fiscal side.

Senator EXON. Your answer, you think, is generally agreed to by most of the money managers?

Mr. VOLCKER. By money managers, do you mean private or Federal Reserve people? I suspect——

Senator EXON. I was thinking of the non-Federal Reserve sector.

Mr. VOLCKER. Yes; you were thinking of the people in the market.

Senator EXON. Right.

Mr. VOLCKER. There I think you would find quite a mixture of views. I am sure my answer is what some of them think, but I think others think that you could have a practical amendment.

FED'S POLICY ON CLASSIFYING LOANS

Senator EXON. One last—this is an observation, and I have listened to a lot of the comment today and your answers, and I suspect that you might not know about this. But the word that I am getting back is that in the national banks around the country, especially in the rural sections, more and more loans are being classified by the regulators. In other words, I have heard that a loan a year ago that was renewed, with no payment on principal and no payment on interest, that loan therefore has been made classified and cannot be renewed, regardless of the security behind the loan. I do not expect you to know offhand about that, but let me ask the question this way. Is there any policy directed by the Fed at the present time that any loan, regardless of collateral, would be classified if there was no payment on principal or interest the last time it was renewed?

Mr. VOLCKER. No; I do not believe, regardless of the other provisions of that loan and other——

Senator EXON. Essentially collateral——

Mr. VOLCKER. Are you assuming the interest is current?

Senator EXON. Well, I am hearing—and maybe I am hearing wrong—but I am hearing that in some areas of the country, at least, some of the tightening that has happened on consumer credit and agricultural credit in particular is that the banks are getting the message that the regulators are becoming less and less receptive to the idea of justifying the loan other than on its renewal.

Mr. VOLCKER. Let me speak for myself and the Federal Reserve. Senator Grassley raised this question earlier. You referred to national banks; we do not supervise the national banks——

Senator EXON. No; but you influence them.

Mr. VOLCKER. I will speak for the Federal Reserve, which means State member banks, which means a minority of the banks in this respect.

I have raised precisely the question you are raising: have we either consciously or unconsciously tightened up our policies in these respects? The answer that I have received is an unequivocal "no."

Senator EXON. Thank you, Mr. Chairman.

With that, we thank you for being here and being responsive once again.

The committee meeting is adjourned.

[Whereupon, at 1:02 p.m., the committee was adjourned.].

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